

The Lax Enforcement of Section 304 of Sarbanes-Oxley: Why is the SEC Ignoring Its Greatest Asset in the Fight Against Corporate Misconduct?

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Imagine if someone told you that they would take away half of everything you earned this year if you did not catch the misconduct of one of your employees.¹ You would most likely be highly motivated to catch the misconduct. This is exactly what Section 304 of the Sarbanes-Oxley Act does. Or, at least, that is what it is supposed to do.

I. INTRODUCTION

The Sarbanes-Oxley Act of 2002² (Sarbanes-Oxley) was an expansive reaction to widespread scandal and to the market's perceived lack of corporate accountability.³ One of the strongest incentives contained in this Act is Section 304, which provides for the forfeiture of an entire year's bonuses and incentive compensation received by the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO), whenever corporate misconduct results in the filing of a restatement.⁴ This provision puts the

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¹ See *Special Report: Executive Pay 2004*, USATODAY, May 20, 2005, <http://www.usatoday.com/money/companies/management/2004-ceo-pay-salary-chart.htm> (last visited Oct. 11, 2008) (looking at the total compensation received by the CEOs at the top 225 revenue producing companies). This data shows that 217 out of the 225 CEOs receive more than 70% of their yearly compensation from sources other than salary. *Id.* That 70% is subject to disgorgement under Section 304.

² Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

³ Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. ON REG. 313, 321-23 (2007).

⁴ Sarbanes-Oxley Act of 2002 § 304, states:

§ 304. Forfeiture of certain bonuses and profits

(a) Additional Compensation Prior to Noncompliance with Commission Financial Reporting Requirements

If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial

onus on the executives to go beyond passive observation and actively search out potential sources of fraud and misconduct by imposing on them a personal penalty for failure to discover misconduct.⁵ It also creates one of the strongest incentives to accomplish the direct goal of the Sarbanes-Oxley Legislation—corporate transparency and disclosure.⁶ If enforcement actions under this provision could increase corporate compliance, why is it that such action has been taken in only a handful of cases since its inception?⁷

This Note will attempt to answer this very question by searching for the systemic source of the problem, and exploring possible barriers to efficient enforcement. Part II will address the history and purpose of Sarbanes-Oxley and argue that Congress intended to create an affirmative duty to seek out corporate misconduct through the enactment of Section 304. Part III of this Note will address the operation of Section 304. Part III.A attempts to resolve the ambiguity in the language of the statute in order to provide a clear framework against which to analyze current enforcement statistics. Part III.B explores the lack of enforcement actions brought under Section 304, to date. Part IV proposes several explanations as to why the enforcement under this Section is so low. Part V looks at two proposed amendments to Section 304 and analyzes the effect that the proposed changes would have if enacted.

reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—

(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and

(2) any profits realized from the sale of securities of the issuer during that 12-month period.

(b) Commission Exemption Authority

The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.

Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2006).

⁵ Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 955–57 (2003).

⁶ *Will SOX 304 Spoil the Appetites of Innocent Executives? Misconduct, Disorgement and the SEC*, in 3 PLI'S COMPLIANCE COUNSELOR (Practising Law Institute No. 40, 2006) (describing the Section as “a mighty powerful tool”). Cf. Scott De Carlo, *Executive Pay: Big Paychecks*, FORBES, May 3, 2007, http://www.forbes.com/2007/05/03/ceo-executive-compensation-lead-07ceo-cx_sd_0503ceocompensationintro.html (last visited Oct. 19, 2008) (“The chief executives of America’s 500 biggest companies got a collective 38% pay raise last year, to \$7.5 billion. That’s an average \$15.2 million apiece. Exercised stock options again account for the main component of pay, 48%.”).

⁷ See *infra* Part III.B.

Finally, Part VI puts forth recommendations for clarifying Section 304 and for reaching optimal enforcement under this provision.

II. THE HISTORY OF SARBANES-OXLEY AND SECTION 304

It is a basic assumption of securities law that mandatory disclosure of all material information is necessary if the public market is going to correctly value and freely trade in securities.⁸ Whether one agrees with this assumption,⁹ once the market was designed to function on the principle of total information, the regulations and enforcement procedure must ensure that total information is received.¹⁰ Along these lines, the Securities Exchange Act of 1934 mandates that every publicly traded company file annual and quarterly reports,¹¹ the purpose of which is to allow both current and potential investors access to information on the health of the company, or other information that might have an effect on their evaluations of a security.¹²

A. *The Origins of Sarbanes-Oxley*

A series of corporate scandals first brought to the public's attention a flaw in the system that allowed corporate officers to withhold, misrepresent or downright lie to the public about essential information.¹³ The widespread

⁸ See TERENCE SHEPPEY & ROSS MCGILL, *SARBANES-OXLEY: BUILDING WORKING STRATEGIES FOR COMPLIANCE* 10–11 (2007) (discussing the “information economy”).

⁹ It has been proposed that heavy regulation creates inefficiency in the market and that if there were no regulations “rational cost-benefit analysis” would drive internal controls and disclosures and the market could price the risk of misinformation. HENRY N. BUTLER & LARRY E. RIBSTEIN, *THE SARBANES-OXLEY DEBACLE: WHAT WE’VE LEARNED; HOW TO FIX IT* 23–25 (Michael S. Greve ed., 2006).

¹⁰ Vincent Di Lorenzo, *Does the Law Encourage Unethical Conduct in the Securities Industry?*, 11 *FORDHAM J. CORP. & FIN. L.* 765, 778 (citation omitted) (“[a] fundamental purpose, common to these [federal securities] statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.”).

¹¹ Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m (2006).

¹² See SHEPPEY & MCGILL, *supra* note 8, at 78.

¹³ See SHEPPEY & MCGILL, *supra* note 8, at 7; GUY P. LANDER, *WHAT IS SARBANES-OXLEY?* 1 (McGraw-Hill 2004) (identifying the “corporate giants like Enron, Global Crossing, and WorldCom . . . forced to declare bankruptcy” and the “massive accounting and other irregularities” at Adelphi Communications and other companies as the source of the “public outcry”).

media frenzy, covering everything from embezzlement to insider trading,¹⁴ caused the general public to fear that the information disclosed to the market was not sufficiently truthful or dependable. The concern became that investors had lost confidence in the market and would pull their money out of the market, leading to an economic downturn if something was not done to fix the problem.¹⁵

Congress's reaction (or overreaction¹⁶) to the perceived decrease in investor confidence¹⁷ was the enactment of Sarbanes-Oxley.¹⁸ Previous legislation has been proposed to "deter . . . market abuse which threatens investor confidence in the fairness and integrity of [the] capital markets by undermining the public's expectations of honest and fair securities markets where all participants play by the same rules."¹⁹ The Sarbanes-Oxley Act was no different in this respect. Congress sought "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws."²⁰ It sought to accomplish greater

¹⁴ Media coverage that was "unrelentingly negative on business" may have exaggerated the problem through excessive attention. BUTLER & RIBSTEIN, *supra* note 9, at 10.

¹⁵ See 148 CONG. REC. H4357 (July 9, 2002) (statement of Rep. Inslee) ("[T]here has been so much malfeasance [and] . . . this has created a substantial lack of confidence in our capital markets system. It is clear that we have a very systemic problem we have got to fix."); 148 CONG. REC. E1451 (July 25, 2002) (Conf. Rep., Extension of Remarks) (statement of Rep. Sununu) ("Americans, have watched the stock market tumble as accounting scandals have shaken investor confidence.").

¹⁶ Many have commented that Sarbanes-Oxley was a poorly drafted, and hastily executed, regulation that did more harm to the market than good. See BUTLER & RIBSTEIN, *supra* note 9, at 100; SHEPPEY & MCGILL, *supra* note 8, at 19 ("An underlying issue for many . . . is the concern that the industry is being over-regulated as a reaction to perceived failures of processes and controls within individual firms, rather than widespread systemic issues requiring regulatory control."); Thuy-Nga T. Vo, *Lifting the Curse of the SOX Through Employee Assessments of the Internal Control Environment*, 56 U. KAN. L. REV. 1, 2 (2007) (characterizing Sarbanes-Oxley as a "curse" on the business community).

¹⁷ The SEC has pointed to Sarbanes-Oxley as a means of providing the public "with a materially accurate and complete picture of an issuer's financial condition." Final Rule and Request for Comments; Certification of Disclosure in Companies' Quarterly and Annual Reports Progression and Development, 17 C.F.R. pts. 228, 229, 232, 240, 249, 270, 274 (2006).

¹⁸ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. & 18 U.S.C.).

¹⁹ See Marc I. Steinberg & Ralph C. Ferrara, *Securities Practice: Federal and State Enforcement*, 25 Sec. L. Ser. (West) app. 2D, at 2-177 (2004) (Statement of Senator Sarbanes, excerpt from debate over Insider Trading Sanctions Act of 1984).

²⁰ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 745 (2006). See also Oleg Rezzzy, *Sarbanes-Oxley: Progressive Punishment for Regressive Victimization*,

transparency by mandating extensive auditing, internal monitoring compliance procedures and by attaching liability to company executives responsible for financial disclosure.²¹ It was not the goal, but the means of accomplishing that goal—the statutorily mandated procedures—that made this legislation so noteworthy.

It was not just increased disclosure of information that was needed, since mandatory disclosure was not a new concept in the realm of securities.²² Rather, it was a measure of accountability in the form of a designated person to root out wrongdoing, which was lacking from prior enforcement mechanisms.²³ Hoping to increase the accuracy of periodic filings, Congress enacted the certification requirement of Section 302 of Sarbanes-Oxley.²⁴ “[T]he provision . . . requires the CEOs and CFOs of public companies to personally certify that the reports their companies file with the Commission are both accurate and complete.”²⁵ The goal was to give the market a

44 Hous. L. Rev. 95, 98 (2007) (“Sarbanes-Oxley put forth numerous provisions targeting existing governance and financial reporting weaknesses. . . . Its provisions . . . mandated director independence . . . improved the dissemination and disclosure of material financial and organizational information, and sought to deter future fraud with stiffer criminal sanctions and greater senior executive responsibility.”).

²¹ 148 CONG. REC. E1451 (July 25, 2002) (Conf. Rep., Extension of Remarks) (statement of Rep. Sununu) (“Our action today will inform executives that their actions will be scrutinized, with the threat of real penalties for violations of their legal responsibilities . . . This conference report . . . includes key provisions . . . that will improve disclosure, impose tougher penalties, and better protect investors in such cases of fraud.”).

²² A publicly traded company was required to file quarterly and annual reports under either Section 13 or Section 15(d) of the Securities Exchange Act of 1934. See Robert M. Mattson, Jr. & Tamara Powell Tate, *Periodic Reporting Requirements*, 1-4 Federal Securities Exchange Act of 1934 (MB) § 4.02 (2008); Securities Exchange Act of 1934 §§ 13, 15(d), 15 U.S.C. §§ 78m, 78o(d) (2006).

²³ See S. REP. NO. 107-205, at 25 (2002) (“The Committee believes that management should be held responsible for the financial representations of their companies. The bill therefore clearly establishes that CEOs and CFOs are responsible for the presentation of material in their company’s financial reports.”). Many called for punishment as a means of accountability, and some even desired to “impose the sternest criminal sanctions on the corporate people and accountants who failed to abide by their responsibilities . . . we need CEOs to have to certify their financial records so that they are personally responsible.” 148 CONG. REC. H4357 (July 9, 2002) (statement of Rep. Inslee).

²⁴ Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006).

²⁵ See Press Release, Sec. & Exch. Comm’n, SEC Prepares to Implement Sarbanes-Oxley Act Requirement for CEO and CFO Certification of SEC Filings, SEC Press Release No. 2002-119 (Aug. 2, 2002), available at <http://www.sec.gov/news/press/2002-119.htm>.

designated ally whose duty it was to put a stop to the corruption. But what use is creating a duty without a penalty to motivate one to fulfill that duty?

B. The Expansion of Responsibility and Liability under Section 304

Sarbanes-Oxley sought to increase reporting accuracy by increasing the accountability of those responsible for the disclosures.²⁶ Section 304 is one of many enforcement provisions designed to increase internal investigation and create a penalty for inaccurate or incomplete reports.²⁷ In that respect, Section 302 and Section 304 are two sides of the same coin. Whereas Section 302 creates the incentive for the CEO and CFO to ensure accuracy by attaching liability to their signature, Section 304 creates a penalty for failure to discover corporate misconduct by directly targeting bonuses and incentive based compensation of the CEO and CFO.²⁸ While Section 304 does not directly punish a false signing like Section 906,²⁹ it is still operationally consistent with the duty to obtain all material information about the company and ensure it is accurate and not misleading before issuing the report.³⁰

²⁶ See Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of The Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 3 (2002) ("The only effective antidotes to fraud are active and vigilant markets and professionals with strong incentives to investigate corporate managers and dig up corporate information.").

²⁷ *Id.* at 17–18.

²⁸ Compare Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006), with Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2006).

²⁹ Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C. § 1350 (2006).

³⁰ See Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006) for the basis of the duty to investigate:

§ 7241(a)(2): based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

§ 7241(a)(3): based on such officer's knowledge, the financial statements . . . fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

§ 7241(a)(4)(B): the signing officers . . . have designed such internal controls to ensure that material information relating to the issuer . . . is made known to such officers . . . particularly during the period in which the periodic reports are being prepared[.]

This can be read to say the officer is tasked with the knowledge of collecting all "material information" related to the company and certifying based on all the information collected that he has not made any false or misleading statement. This is supported by the fact that he must also disclose any problem in the system that might prevent him from being able to accurately disclose the true state of the company's financials. Sarbanes-

Working in tandem, these two provisions place pressure on the CEO and the CFO to actively investigate, effectively forcing them to ensure that no misconduct is present within the company.³¹

This approach of an affirmative duty to investigate is consistent with past judicial reasoning that rejected the so called “‘good soldier’ defense”³² and “‘ignorance’ defense.”³³ The penalty for false certification is outlined under Section 906, which amended the Securities Exchange Act of 1934³⁴ to impose an additional civil penalty.³⁵ In doing so, it used familiar language, added clarifying amendments, and specifically referenced the section of the code that had to be violated.³⁶ Congress did not choose to add any of these features to the text of Section 304, potentially so that it could create a new standard of liability.³⁷ Additionally, the language of Section 304 seems to

Oxley Act of 2002 § 302(a)(4)–(5), 15 U.S.C. § 7241(a)(4)–(5) (2006). See Paul H. Dawes & Michele D. Johnson, *The Disgorgement Mandates of Sarbanes-Oxley Section 304: Do They Reach Innocent CEOs and CFOs?*, in *SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2006*, at 116 (PLI Corporate Law and Practice Course Handbook Series No. 8805 2006). See also Sarbanes-Oxley Act of 2002 §§ 401, 404, 15 U.S.C. §§ 7261, 7262 (2006).

³¹ Cunningham, *supra* note 5, at 956 (“Keeping the heat on the CEO and CFO . . . is a novel and proportionate penal scheme, intended to destroy what many saw as one part of the incentives for manipulation in the first place. This is also intended to discourage poor accounting treatments that are the product of mere haste, bad judgment, or other carelessness.”).

³² This failure to satisfy an affirmative duty is illustrated in *In re Maury* where Maury, a Controller, “implement[ed] . . . directions which he knew or should have known were improper . . . [and] failed to take adequate steps to satisfy himself that the accounting practices . . . were correct, and that the disclosures made by senior management were accurate.” Marc I. Steinberg & Ralph C. Ferrara, *Securities Practice: Federal and State Enforcement*, 25 Sec. L. Ser. (West) § 2:23, at 2-61 (2004) (citing *In re Maury*, AAER-93, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,493 (Mar. 26, 1986)).

³³ Cunningham, *supra* note 5, at 955–56, states:

These provisions look to prevent CEOs and CFOs from hiding behind the defense of ignorance. The clear line of provenance points to the Enron scandal amid which several senior executives testified before Congress that they lacked knowledge of underlying financial fraud, contending that they couldn’t possibly be aware of all activities, including fraudulent practices, within the massive company.

³⁴ Securities Exchange Act of 1934, 48 Stat. 881 (1934).

³⁵ Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C. § 1350 (2006).

³⁶ *Id.* at § 906(a)–(b).

³⁷ See Stephen Fraidin, Andrew M. Genser & Daniel S. Hoverman, *Payback: Disgorging Bonuses, Equity and Incentive-Based Compensation Under Sarbanes-Oxley’s Section 304*, 2 INT’L J. OF DISCLOSURE & GOVERNANCE 52, 54 (2005) (discussing Section 304’s “apparent introduction of . . . sweeping features [as marking] a radical break from the traditional approach to securities enforcement”). Congress may have intended to remove Section 304 from consideration under any formerly familiar legal standard.

reject³⁸ the Section 302 certification standard of “knowingly” or “based on my knowledge”³⁹ in favor of the broader standard of corporate responsibility: an affirmative duty of acquiring relevant knowledge.

An affirmative standard would also be consistent with the broader SEC purpose—“protection of investors and to insure fair dealing in the security.”⁴⁰ Allowing a CEO to claim ignorance of fraud in the company seems to be in direct contradiction to his Section 302 mandate to set up “internal controls to ensure that material information relating to the issuer . . . is made known to such officers.”⁴¹ Those controls “provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements.”⁴² Because the CEO and CFO are charged with implementing these controls⁴³ in order to aid them in acquiring all “material information,”⁴⁴ it would seem that internal fraud or misconduct would be the type of knowledge they are charged with acquiring, possessing, and correcting.⁴⁵

The original idea for this section came when “President George Bush announced a ten-point plan to improve corporate responsibility One of the President’s proposals was to disallow CEOs and other officers of corporations to profit from erroneous financial statements.”⁴⁶ As phrased,

³⁸ See John P. Kelsh, *Section 304 of the Sarbanes-Oxley Act of 2002: The Case for a Personal Culpability Requirement*, 59 BUS. LAW. 1005, 1017–19, 1024–26 (2004) (explaining that in choosing the Senate version over the House version they rejected the requirement to “‘identify the scienter requirement’”) (citations omitted).

³⁹ Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006).

⁴⁰ Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m(a) (2006).

⁴¹ Sarbanes-Oxley Act of 2002 § 302(4)(B), 15 U.S.C. § 7241(4)(B) (2006).

⁴² 68 Fed. Reg. 36,636, 36,667 (June 18, 2003) (to be codified at 17 C.F.R. pt. 240).

⁴³ Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (2006).

⁴⁴ Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006). See *supra* discussion note 26.

⁴⁵ Sarbanes-Oxley Section 302(a)(5) states that the certifier must disclose to the auditors “any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer’s internal controls” presumably because it would signal “material weaknesses in internal controls” and therefore prevent the issuer from correctly identifying or representing material information. Sarbanes-Oxley Act of 2002 § 302(5)(B), (A), 15 U.S.C. § 7241(5)(B), (A) (2006). If the CEO or CFO is already supposed to know of any fraud or deficiency that might prevent him from getting the accurate information then it seems entirely reasonable to punish them when they did not acquire the knowledge the law dictated that they should have already acquired.

⁴⁶ Harold S. Bloomenthal, *SEC Disgorgement Strengthened and/or Opportunities for Plaintiffs’ Lawyers?*, 25 SEC. & FED. CORP. L. (West) No. 1, at 4 (Jan. 2003). See also H.R. REP. NO. 107-414, at 50 (2002) (“to require disgorgement of incentive-based

this proposal was consistent with the policy of disgorgement that was already present in many securities regulations.⁴⁷ “[T]he primary purpose of disgorgement is not to compensate investors. Unlike damages, it is a method of forcing a defendant to give up the amount by which he was unjustly enriched.”⁴⁸ The final language of Section 304 was added to the Act during a conference committee session,⁴⁹ replacing language reported out of committee that only would have tasked the SEC to investigate the matter.⁵⁰ The language eventually enacted by Congress expands on the originally intended application.⁵¹

Before the Sarbanes-Oxley Act was enacted, the traditional causes of action contained either a knowledge element or liability for direct action.⁵² A cause of action under Section 304 appears to have neither a knowledge

compensation from officers and directors in cases of false or misleading statements made by such officers that required an accounting restatement.”).

⁴⁷ See, e.g., Bloomenthal, *supra* note 46, at 4. The SEC brought action against the Rigas for “fraudulent misrepresentations and omissions of material fact . . . [seeking] disgorgement of any and all compensation . . . before the adoption of Sarbanes-Oxley; hence, it is clear that the Commission assumed it had authority to expand the disgorgement remedy in this fashion.” *Id.*

⁴⁸ SEC v. Tome, 833 F.2d 1086, 1096 (2d Cir. 1987) (citing SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 102 (2d Cir. 1978)).

⁴⁹ H.R. REP. NO. 107-610, at 35 (2002) (Conf. Rep.), as reprinted in 2002 U.S.C.C.A.N. 542, 542.

⁵⁰ Representative Oxley felt the language of the bill reported out of committee was not strong enough with respect to disgorgement. See H.R. REP. NO. 107-414, at 50 (2002) (“Instead of attempting to implement this straightforward and common sense proposal [the president’s proposal], the Committee simply tasked the SEC to study the question of disgorgement.”).

⁵¹ Bloomenthal posits that the disgorgement authority of Section 304 was intended to expand beyond the Commission’s already existing authority. See Bloomenthal, *supra* note 46, at 4–5 (“For years, the Commission, in civil actions, typically sought . . . disgorgement of ill-gotten gains . . . [t]here does not appear to be a need for any additional authority . . . Why then, the provisions of Section 304 . . . ?”).

⁵² See Kelsh, *supra* note 38, at 1024–27 (“[T]he pre-Sarbanes-Oxley liability provisions in the federal securities laws may profitably be divided into three categories: (i) Those that impose liability on a person for an action that he or she has taken, but provide a defense based on the person’s state of mind with respect to the action. . . . (ii) Those that impose liability on a person for an action that he or she has taken, but do not provide a defense based on the person’s state of mind with respect to the action. . . . (iii) Those that impose liability on a person for actions that others have taken, but that provide a defense based on the person’s state of mind with respect to the actions of such other person.”).

requirement, nor an intent requirement.⁵³ A literal reading of Section 304 actually expands the duties and responsibilities of the CEO and CFO; it holds them liable for any misconduct that might lead to a restatement, not just their own.⁵⁴ Therefore, the Section 304 provision instituted a strict penalty for failure to discover corporate misconduct,⁵⁵ not just to deprive one who had been “unjustly enriched.” Given that at the time of enactment many members of Congress were responding to the popular media bias and prominent political rhetoric that all CEOs were crooks;⁵⁶ it is not surprising that such a penalty would have found popular support.⁵⁷

The inattentive liability standard is a significant change from the pre-Sarbanes-Oxley law,⁵⁸ which only allowed an individual’s compensation to be targeted if it was a result of his own misconduct.⁵⁹ The final language of

⁵³ Fraidin et al., *supra* note 37, at 54 (“Section 304 . . . goes beyond other provisions . . . [which require] false certification knowingly . . . regardless of wrongful intent [and] without any fault”).

⁵⁴ Ribstein, *supra* note 26, at 17–18 (“It . . . penalizes fraud by requiring the return of incentive based compensation or profits from stock sales following accounting restatements resulting from ‘misconduct’ whether or not by the executive whose compensation or profits had to be returned.”); Paul H. Dawes & Kory Sorrell, *Stock Options: Past Practices and Narrowing Choices Amid the Backdating Scandal*, WALL STREET LAWYER (West Legalworks, New York, NY), Sept. 2006, at 5 (“Sarbanes-Oxley appears to provide for strict liability of the CFO and CEO, even if they were not guilty of the misconduct leading to the restatement.”).

⁵⁵ Fraidin et al., *supra* note 37, at 53–54 (“Read literally, Section 304 imposes strict liability on CEOs and CFOs.”).

⁵⁶ 148 CONG. REC. H4472–73 (daily ed. July 10, 2002) (statement of Rep. Ganske) (“[T]oday the foundation of personal integrity has been eroded by the lure of huge personal profits . . . I think that the rule of law requires that those CEOs who have committed malfeasance, who are no better than street thugs, should spend time in jail.”). See also Cory L. Braddock, Comment, *Penny Wise, Pound Foolish: Why Investors would be Foolish to Pay a Penny or a Pound for the Protections Provided by Sarbanes-Oxley*, 2006 BYU L. REV. 175, 189 (2006).

⁵⁷ 148 CONG. REC. H5462, H5464 (daily ed. July 25, 2002) (statement of Rep. Sensenbrenner discussing H.R. REP. NO. 107-610 (2002) (Conf. Rep.)) (“I said the best way to do that is to punish the corporate wrongdoers and to punish them harshly . . . the conference committee report before us today accomplishes that goal.”); Kelsh, *supra* note 38, at 1022 (“That some of these officers may have been unaware of the extent of the fraud at the companies they lead only served to exacerbate, not alleviate, the outrage.”).

⁵⁸ Kelsh, *supra* note 38, at 1010 (“If . . . misconduct on the part of any person can give rise to liability for the CEO and CFO . . . then section 304 will turn out to be a revolutionary development in the securities laws . . .”).

⁵⁹ See Bloomenthal, *supra* note 46, at 4–5 (“What is different about these cases is that they involve financial fraud by public companies and the disgorgement sought is not funds received from investors but bonuses, other compensation received from the company”); Jeannie Nelson, Comment, *New Corporate Responsibility Law Increases*

Section 304 is missing the critical element of harm, allowing the mere occurrence of a restatement due to misconduct to be enough to trigger disgorgement,⁶⁰ ironically creating the potential to subject the executives to disgorgement even if the restatement has a positive impact on the value of the security.⁶¹ However, merely characterizing the statute as a penalty for failure to discover all corporate misconduct ignores several ambiguities in the statutory text that could wholly change the interpretation of this section.

III. THE INTERPRETATION AND OPERATION OF SECTION 304

In order to analyze the effectiveness and enforcement under Section 304, one must first address its intended operation and function. Part III.A will look at the ambiguous language of the text of Section 304 and will attempt to resolve the ambiguity with the most logical construction. Only after addressing the ambiguities, and attempting to resolve them with their most likely implications, can one even begin to address the lack of action brought under this provision. On the issue of a private right of action, Part III.A.4 of this Note defers to the holdings of the federal courts, which have unanimously ruled that there is no private right of action under Section 304. Part III.B will address the SEC's overall lack of enforcement actions brought under Section 304. Finally, Part III.C will look at the five cases in which the SEC has brought a Section 304 cause of action and attempt to identify similarities between the cases to see if it is suggestive of a trend in enforcement.

A. *The Ambiguous Language of 304 (What Happens When You Rush)*

Statutory canons dictate that interpretation of a statute should start with the text of the act itself.⁶² Unfortunately, the text of Section 304 raises

Liabilities for Directors, Officers, and Attorneys, but Does It Increase Protections for Investors?, 34 TEX. TECH L. REV. 1165, 1196 (2003) ("the Act reduces the protections that were once provided by the corporate veil doctrine").

⁶⁰ 10 ROBERT J. WILD, DESIGNING AN EFFECTIVE SECURITIES COMPLIANCE PROGRAM § 1:152 (2007).

⁶¹ Cf. John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 312–13 (2004) ("Not all restatements . . . are equal. Some may . . . involve only trivial changes or . . . could simply be the product of changes in regulatory rules and could signify relatively little.").

⁶² See *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253–54 (1992) ("[I]n interpreting a statute a court should always turn first to one, cardinal canon before all others . . . courts must presume that a legislature says in a statute what it means and means in a statute what it says there."); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (citation omitted) ("The starting point in every case involving construction of a statute is the language itself.") .

several problems of interpretation due to poor drafting and ambiguous language.⁶³ Section 304, Forfeiture of Certain Bonuses and Profits, states:

(a) Additional Compensation Prior to Noncompliance with Commission Financial Reporting Requirements. — If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—

(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and

(2) any profits realized from the sale of securities of the issuer during that 12-month period.

(b) Commission Exemption Authority. — The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.⁶⁴

While at first glance the language seems straightforward, it is actually unclear in regard to many areas of implementation. Its first problem is the total failure of the drafters to define “misconduct,” the triggering threshold for imposition of liability.⁶⁵ Second, it fails to either differentiate between the responsibility of the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO), or specifically include both as liable for misconduct resulting in a restatement.⁶⁶ Third, some have argued that the language defining the types of instruments covered by forfeiture is vague, making calculation of the amount of disgorgement very difficult.⁶⁷ Finally, while designating exemption authority, it fails to specify the enforcing authority or who is specifically permitted to bring a cause of action.⁶⁸

⁶³ 18 DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT, AND PREVENTION § 10:10.50 (2007). *See also* Ramirez, *supra* note 3, at 323–24 (noting problems with hasty enactment of Sarbanes-Oxley and the resulting poorly drafted legislation).

⁶⁴ Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2006).

⁶⁵ *See* Dawes & Johnson, *supra* note 30, at 113.

⁶⁶ *See* WILD, *supra* note 60, at §1:152.

⁶⁷ Fraidin et al., *supra* note 37, at 60–61.

⁶⁸ *See* Neer v. Pelino, 389 F. Supp. 2d 648, 652 (E.D. Pa. 2005).

1. “Misconduct”: Congress’s Failure to Be Specific

Section 304 “was a late addition to the legislation, and hardly is a model of clear drafting.”⁶⁹ The whole section is triggered by the need to issue a restatement due to “misconduct,” yet nowhere in the Act does Congress define the term.⁷⁰ First, “[t]his forfeiture provision does not provide specifics as to the meaning or degree of actionable misconduct” and second, “does not require that the misconduct be committed by the CEO and the CFO who are subject to the forfeiture.”⁷¹ Under the current language, it is conceivable that even the most diligent executive, who strives to find any hint of corporate misconduct, might still be subject to the disgorgement through no fault of his own.⁷²

It is the “misconduct” that triggers the disgorgement, “not [just] the mere decision to restate financial reports,” but the text does not specify the degree of misconduct.⁷³ The language when reported out of the committee in the House set the threshold at “extreme misconduct,” but the “extreme” qualifier was specifically rejected in the final draft, causing the triggering threshold to be lower than that originally purposed.⁷⁴ However, this does not resolve the threshold level of misconduct, and thus the requisite elements of a 304 cause of action are unclear. Can “negligent errors . . . be sufficient to trigger the disgorgement provision[?]”⁷⁵ It appears that the restatement must be due to someone’s misconduct, “something more than a mistake,”⁷⁶ that rises to the level of intent to act in a manner inconsistent with the securities laws and filing requirements. But, this reveals the second point of ambiguity, since it is not the CEO or the CFO that has to make that conscious choice of non-compliance.⁷⁷ Thus, while someone in the company must be intentionally acting, the text seems to sever the intent to act from the punishment.

Reading the text in this manner is consistent with the goal of the legislation, to create an affirmative duty to acquire knowledge about the

⁶⁹ LANGEVOORT, *supra* note 63, at § 10:10.50.

⁷⁰ Dawes & Johnson, *supra* note 30, at 113.

⁷¹ WILD, *supra* note 60, at §1:152.

⁷² Dawes & Johnson, *supra* note 30, at 114 (“[T]he Act’s silence as to the source of the misconduct that triggers disgorgement could be interpreted as an indication that the disgorgement mandate reaches even innocent and diligent company executives.”).

⁷³ *In Re AFC Enters., Inc. Derivative Litig.*, 224 F.R.D. 515, 521 (N.D. Ga. 2004).

⁷⁴ *Neer v. Pelino*, 389 F. Supp. 2d 648, 656 (E.D. Pa. 2005) (“‘extreme misconduct’ . . . [e]stablishing such a high standard will make it very difficult, if not impossible, for the commission to obtain disgorgement”). See also H.R. REP. NO. 107-414 (2002).

⁷⁵ Dawes & Johnson, *supra* note 30, at 116.

⁷⁶ *Id.*

⁷⁷ Kelsh, *supra* note 38, at 1015–16.

company and to seek out misconduct. Such an application is consistent with the President's proposal as well as the statutory purpose.⁷⁸ Given that most of the Sarbanes-Oxley provisions are targeted at catching corporate fraud, it would be consistent with the holistic purpose of the legislation to presume that Congress was attempting to incentivize executives to actively seek out the fraud.⁷⁹ The punishment is imposed because executives failed to do their jobs, i.e. ensure the financial integrity of the company and the accuracy of the financial disclosures, so it is entirely logical that the deprivation of benefits is due not to their own personal misconduct, but their failure to pay attention and investigate.⁸⁰ The forfeiture provision should be read as a punishment for *inattentive* CEOs that fail to catch the misconduct happening within their corporations.⁸¹

However, "[t]his provision focuses on material noncompliance with financial reporting requirements, without a requirement that the restatement be adverse."⁸² The lack of harm caused by the misconduct would not be inconsistent with the characterization of this provision as a strict liability penalty.⁸³ In the case of a strict liability standard, it is not the executives'

⁷⁸ Dawes & Johnson, *supra* note 30, at 114.

⁷⁹ SHEPPEY & MCGILL, *supra* note 8, at 78 ("In addressing reliability of reports, the Act seeks to ensure good practical corporate behavior . . . [with] emphasis placed on senior executives. Financial reports, interim and final, are the stuff of their world. It is they who are directly associated with these statements. . . . [and] [i]t is they who are directly tasked with ensuring transparency, and it is they who are penalized for failures.").

⁸⁰ Scott Harshbarger & Goutam U. Jois, *Looking Back and Looking Forward: Sarbanes-Oxley and the Future of Corporate Governance*, 40 AKRON L. REV. 1, 29 (2007) ("If executives are truly to have an incentive to manage a company ethically, they should forfeit pay when material noncompliance happens on their watch.").

⁸¹ One scholar argues that "[o]ne could also imagine circumstances in which the 'misconduct' is on the part of a lower level employee, and that it is patently unreasonable to assume that the chief executive officer or chief financial officer would be able to discover or control such conduct." Stanton P. Eigenbrodt, *The Chilling Effects of Disgorgement and a Temporary Freeze: Sarbanes-Oxley Sections 304 and 1103*, 2004 BUREAU OF NAT'L AFFAIRS 2, available at http://media.gibsondunn.com/fstore/documents/pubs/Eigenbrodt_5_2004.pdf. However, misconduct that created a situation which can trigger a restatement is unlikely to be committed by such a low-level employee and not be identified by the internal controls. If such an occurrence happens, this author argues that it would be the result of either a deficiency in the control or fraud by a party involved in the internal control system, both of which the CEO and CFO are required to identify under Section 302. See discussion *supra* Part II.B.

⁸² WILD, *supra* note 60, at § 1:152.

⁸³ Peter L. Welsh, *Courts Deny Plaintiffs' Lawyers a Role in Enforcing Sarbanes-Oxley Section 304*, LEGAL BACKGROUNDER, Jan. 13, 2006, available at <http://www.wlf.org/upload/011306LBWelsh.pdf> (Section 304 "was intended to provide a nearly automatic mechanism for compelling . . . [a CEO and CFO] to disgorge bonuses,

indifference or passive certification that is targeted, it is the failure to find the fraud that is punished, regardless of how much time, effort, or money was invested in the investigation.⁸⁴ Such a reading of the provision would certainly create a strong incentive for executives to truly investigate what was transpiring within their corporations.⁸⁵

However, by using the strict liability interpretation, several negative outcomes could result. First, there is such a thing as being too careful. It is entirely conceivable that dutiful executives would spend excessive amounts of time and corporate resources to ensure the absences of misconduct, well beyond any reasonable cost-benefit analysis.⁸⁶ Second, tying the incentive to the personal compensation of the executives could force them to put their own motivation to retain their earnings above what is in the best interest of the company.⁸⁷ Finally, such a reading also creates large personal risk for executives, potentially resulting in a significant increase in the cost of directors' and officers' insurance, or the possibility that talented officers will

equity gains, and other incentive-based compensation"). See also David A. Westbrook, *In the Wake of Corporate Reform: One Year in the Life of Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 441, 449 (2004) ("Unlike fraud, failure to meet one's reporting obligations is illegal regardless of whether any investor was actually misled or even injured.").

⁸⁴ Fraidin et al., *supra* note 37, at 53–54 ("Section 304 imposes strict liability . . . in amounts that bear no logical relation to the scope of misconduct or to the harm inflicted on others . . . liability that a covered officer cannot avoid even by the strictest adherence to the securities laws."). In this respect the Section 304 standard is similar to some states' absolute standard for statutory rape: the law does not care if a man asked for the girl's driver's license, birth certificate, and passport, and she looked 25. If she was under the age of consent, he would still be guilty. See, e.g., *State v. Berry*, 117 N.H. 352 (N.H. 1977) ("Our statutory rape statutes have always applied to those under the age of consent regardless of their maturity and the fact that a female's apparent maturity may mislead a man into believing she is older than sixteen has been no defense.")

⁸⁵ Cf. Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 448 (2005–2006) ("[T]he market may provide a strong incentive to . . . publish overly optimistic news while ignoring red flags and failing to scrutinize . . . conduct. Because of this incentive, our corporate governance system needs legal sanctions to serve as a countervailing force, pressuring directors to pay heed to their fiduciary responsibility of ensuring . . . disclosure."). Section 304 creates the similar "countervailing force" in the case of officers. *Id.*

⁸⁶ BUTLER & RIBSTEIN, *supra* note 9, at 49, 58–59. Cf. William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private,"* 55 EMORY L.J. 141 (2006) ("All internal control systems can be defeated by a conspiracy among employees to commit fraud, so section 404 becomes a due diligence standard rather than antifraud protection."). If an executive is required to use due diligence in his efforts to search for misconduct, then due diligence should also become an affirmative defense to Section 304 actions.

⁸⁷ BUTLER & RIBSTEIN, *supra* note 9, at 49, 58–59.

find the risk too high and simply choose not to work for publicly traded companies.⁸⁸ Ironically, this could deter the savviest businessmen—those who would be most likely to catch the fraud or misconduct—from accepting the position.⁸⁹ Therefore, the strict liability reading would fail to accomplish the goals of the Act.

The alternative interpretation, the direct liability or personal culpability interpretation, where the disgorgement would be tied only to misconduct committed by the CEOs and CFOs, would be consistent with the default condition before the enactment of Sarbanes-Oxley⁹⁰ where one had to show both fault and harm to seek disgorgement of an executive's compensation, similar to an action for insider trading.⁹¹ Many academics have rejected this interpretation on the grounds that if such an action could have been brought before the enactment of Sarbanes-Oxley, then the language of Section 304 is rendered entirely superfluous.⁹²

⁸⁸ *Id.* at 51–53.

⁸⁹ Compare Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 33-8177, 17 C.F.R. Pts. 228, 229 & 249 (Jan. 24, 2003) available at <http://www.sec.gov/rules/final/33-8177.htm> (extensive discussion on “financial expert” requirement), with David McCann, *Why is CFO Turnover So High?*, CFO MAGAZINE, Feb. 29, 2008, <http://www.cfo.com/article.cfm/10789703?f=insidecfo> (“CFOs’ legal liability for errors has skyrocketed. . . . more are coming to believe that the financial rewards just aren’t as attractive in the face of this elevated risk . . . As CFOs get older, their wariness may grow sharper. ‘Increased exposure has been very dramatic, and CFOs may be thinking that the longer they stay, the greater the potential that there will be some kind of issue.’”).

⁹⁰ The enforcement provision governing Sarbanes-Oxley Act § 3(b)(1), states: “A violation by any person of this Act . . . shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.),” which was already the legislative regime in place. Sarbanes-Oxley Act of 2002 § 3(b)(1), 15 U.S.C. § 7202 (2006).

⁹¹ Kelsh, *supra* note 38, at 1010 (“If, however, section 304 is interpreted so that liability is imposed only if the Covered Officer has engaged in violations of the securities laws, then the provision will turn out to be far less significant as . . . it will merely clarify the contours of the [already existing] disgorgement remedy. . . .” (punctuation omitted)).

⁹² A common justification for adopting the misconduct definition that has a threshold at negligent conduct, or less, is due to the statutory interpretation canon known as the Rule Against Surplusage, which proposes that new statutory text is put in place to effectuate a change. *Cf.* Bloomenthal, *supra* note 46, at 4. Following this reasoning, the statutory language should be given independent effect and not be given a “reading [that] would render the regulation entirely superfluous . . . or] mere surplusage,” since the Court has “cautioned against reading a text in a way that makes part of it redundant.” *Nat’l Ass’n of Home Builders v. Defenders of Wildlife*, 127 S. Ct. 2518, 2535–36 (2007) (referencing *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001)).

Additionally, the scandals in the late 1990s have made it clear that the previous securities regulations were not effective in preventing the fraud.⁹³ This is supported by the fact that Sarbanes-Oxley also contains Section 906, which imposes a penalty for knowingly certifying a report that is false⁹⁴ and Section 807, which punishes intentional fraud.⁹⁵ To give the term “misconduct” any effect, the language must be a development from the pre-Sarbanes-Oxley enforcement provisions. Therefore, the intermediate standard of liability for inattentiveness seems most likely to approach the textual and congressional understandings of the statute. As such, it is only apprehension of incurring unintended consequences that appears to be deterring the SEC from aggressive enforcement.

2. Failure to Differentiate Between the Duties of the Certifiers

The “inattentive” interpretation must be differentiated further. Not only does the text not say whose or how much misconducts triggers the forfeiture, but it also fails to differentiate between the CEO and the CFO.⁹⁶ Typically, reports and filings are not solely prepared by either the CEO or the CFO, and portions of the report would seem to be mostly the responsibility of one executive or another.⁹⁷ The language seems to suggest that even if the error that caused the non-compliance is contained in a portion of the report that typically only the CEO would prepare, both the CEO and CFO would have to forfeit their bonuses.⁹⁸ However, since both the CEO and the CFO must certify the reports under 302,⁹⁹ they both become subject to the disgorgement if there is any misconduct that is not caught and results in a restatement. This interpretation is consistent with the congressional desire to create an incentive to affirmatively seek out misconduct. Presumably, Congress wanted to add the additional requirement that executives had to check each

⁹³ See Westbrook, *supra* note 83, at 446 (“whether that be the Crash of ‘29 or Enron, neither of which were prevented by existing law. . . . Crisis thus reveals the inadequacy of existing law”).

⁹⁴ Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C. § 1349 (2006).

⁹⁵ Sarbanes-Oxley Act of 2002 § 807, 18 U.S.C. § 1348 (2006).

⁹⁶ See WILD, *supra* note 60, at §1:152.

⁹⁷ While it is likely the CEO would be held responsible for all aspects of the report, both financial and non-financial, it seems counterintuitive to have the CFO required to oversee all company operations in order to avoid potential liability.

⁹⁸ Looking at Section 302, which required the “principal executive officer . . . and the principal financial officer” to certify the reports, and the language of Section 304, which uses the conjunction “and,” the plain language seems to suggest that the disgorgement applies to both CEO and CFO at the same time. Sarbanes-Oxley Act of 2002 §§ 302, 304, 15 U.S.C. §§ 7241, 7243 (2006).

⁹⁹ Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006).

other's work to ensure accuracy, but at the same time this seems to create redundancy of tasks. If the CEO cannot trust that the CFO has discovered the financial fraud that he is responsible for, he will have to redo a significant portion of the investigation that was already conducted by the CFO. Such massive inefficiency would not likely be in the best interest of the company and would again raise the incentive problem of whether the executives were acting in the best interest of the company or themselves.¹⁰⁰

However, it is an understood necessity in corporations to rely on the internal controls and audit systems to catch corporate misconduct, and this system of redundant accuracy checks was mandated by Congress.¹⁰¹ Given that Congress favored a policy of redundancy, one should not then use this redundancy as a justification for reading the plain conjunctive article "and" to mean "or."¹⁰² Congress viewed both executives as directly responsible for the accuracy of every piece of information disclosed to the public, and thus enforcement actions under Section 304 should be simultaneously brought against the CEO and CFO.

3. Failure to Specify the Amount of Profits that Would Need to be Disgorged

One commentator has posited that "the provision does not specify whether the disgorged profits on options, or from stock incentive, deferred compensation or similar plans, whose total value may reflect years of appreciation, are measured by reference to the appreciation in the year of payment or over all of the years preceding the date of payment."¹⁰³ Here the language seems to be creating a remedy similar to that in insider trading. If the goal is to prevent executives from making profit when the public has been misinformed, (i.e. received less information than the executive), it seems that any sale of a security during the twelve-month period is fairly straight forward, as is any new bonus or option or compensation that is given

¹⁰⁰ BUTLER AND RIBSTEIN, *supra* note 9, at 56–57.

¹⁰¹ See Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (2006). See also Aulana Peters, *Sarbanes-Oxley Act of 2002, Congress' Response to Corporate Scandals: Will the New Rules Guarantee 'Good' Governance and Avoid Future Scandals?*, 28 NOVA L. REV. 283, 286 (2004) ("SEC rules are designed to facilitate the flow of information from management, auditors, and other advisors, to shareholders and boards of directors, to . . . provide an opportunity for and encourage directors to probe and test management's decisions.").

¹⁰² *United States v. Fisk*, 70 U.S. 445, 447–48 (1865) (refusing to read "and" as meaning "or" because to construe otherwise would have made the language act as an "amendment thereof in direct contradiction of its language" and against "the clear intention of the legislature").

¹⁰³ WILD, *supra* note 60, at § 1:152.

or created within that period. The value of disgorgement must be equal to the price at the time of the triggering event.¹⁰⁴ To attempt to distinguish the potential value of appreciation for a twelve-month period absent a triggering event would be inconsistent with the means of calculating the value of assets in the current tax and security systems.¹⁰⁵

4. *Failure to Designate a Specific Means of Enforcement— Is There a Private Right of Action?*

While Congress gave the SEC specific exemption authority, the language does not explicitly state that only the SEC can bring these causes of action. However, this problem has mostly been resolved in the circuit courts, which have determined that there is no private right of action under Section 304, and that only the SEC has a right to bring this cause of action.¹⁰⁶

¹⁰⁴ All the values under this approach are readily able to be calculated: the price of the security when sold and the amount of the bonus are easily identifiable. For the rest the company will just treat any options or incentives granted within that time period as if they never existed or were not issued. If sold it is the price of the sale. See 1-5 Tax Planning for Corporations and Shareholders (MB) § 5.01 (2007).

¹⁰⁵ See 1-5 Tax Planning for Corporations and Shareholders (MB) § 5.03 (2007) (“The ideal tax treatment is usually to refrain from treating the grant of the option as itself being a taxable event. . . . the exercise of the option should simply be considered a purchase at a prior negotiated price, with no present tax consequences on that account. The cost of the stock will be the purchaser’s tax basis for the stock, and if and when he later sells the stock, he will recognize gain or loss at that time.”).

¹⁰⁶ See *In re BISYS Group Inc. Derivative Action*, 396 F. Supp. 2d 463, 464 (S.D.N.Y. 2005); *Neer v. Pelino*, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005). See also *In re Digimarc Corp. Derivative Litig.*, 549 F.3d 1223, 1232 (9th Cir. 2008); *Pedroli v. Bartek*, 564 F. Supp. 2d 683, 686 (E.D. Tex. 2008); *In re Diebold Derivative Litig.*, Nos. 5:06-233, 5:06-418, 2008 WL 564824, at *2 (N.D. Ohio 2008); *In re iBasis, Inc. Derivative Litig.*, 532 F. Supp. 2d 214, 223–25 (D. Mass. 2007); *In re Infosonics Corp. Derivative Litig.*, No. 06-1336, 2007 WL 2572276, at *8–9 (S.D. Cal. 2007) (Slip Copy); *In re Goodyear Tire & Rubber Co. Derivative Litig.*, No. 5:03-2180, 2007 WL 43557, at *7 (N.D. Ohio 2007) (Slip Copy); *In re Intelligroup Sec. Litig.*, 468 F. Supp. 2d 670 (D.N.J. 2006); *Andropolis v. Snyder*, No. 65-01563, 2006 WL 2226189, at *5 (slip copy) Fed. Sec. L. Rep. (CCH) ¶ 93,930 (D. Colo. 2006); *Kogan v. Robinson*, 432 F. Supp. 2d 1075, 1082 (S.D. Cal. 2006); *In re Whitehall Jewellers, Inc. Shareholder Derivative Litig.*, No. 05-1050, 2006 WL 468012, at *7 (N.D. Ill. 2006); *Mehlenbacher v. Jitaru*, No. 6:04-1118, 2005 U.S. Dist. LEXIS 42007, at *31 (M.D. Fla. 2005); *Wuliger v. Sewell*, 363 F. Supp. 2d 940, 950–51 (N.D. Ohio 2005).

Some have expressed doubt, but did not consider the issue. *In re Cree, Inc. Sec. Litig.*, Fed. Sec. L. Rep. (CCH) ¶ 93, 327, 2005 U.S. Dist. LEXIS 21975, at 49–51 (M.D. N.C. 2005). Others have brought this claim but the court dismissed without reaching the issue. See *In re CNET Networks, Inc. Shareholder Derivative Litig.*, 483 F. Supp. 2d 947 (N.D. Cal. 2007); *In re First Bancorp Derivative Litig.*, 465 F. Supp. 2d 112, 117 (D. Puerto Rico 2006); *Weisler v. Barrows*, 2006 WL 3201882, at *1 (D. Del. 2006); *In re*

Initially, the courts approached this problem by applying the four-part *Cort* test for determining if an implicit, private right of action exists.¹⁰⁷ The focus of this approach was then narrowed by holding that the legislative history dispositively concluded that there was no congressional intent to create a private right of action.¹⁰⁸ To determine the legislative intent, the courts looked first to the legislative history and found that it “suggests strongly that Congress intended that Section 304 be enforced only by the Securities and Exchange Commission.”¹⁰⁹

Additionally, the courts went further, adopting a holistic view of the statutory interpretation of Sarbanes-Oxley, and used this to support their finding of congressional intent.¹¹⁰ The courts feel that a “Congressional intent to grant such a remedy is not evident in the text and structure of the statute, particularly where Congress has explicitly created a private remedy in a neighboring provision but did not do so in Section 304 . . . this Court declines to imply a private right of action.”¹¹¹ In adopting the principle of “*expressio unius est exclusio alterius*,”¹¹² the courts may be attempting to limit the amount of shareholder litigation that can be brought, which many scholars already feel is excessive.¹¹³ The issue has been heard by courts in

Ferro Corp. Derivative Litig., 2006 WL 2038659, at *8 (N.D. Ohio 2006); *In re Friedman’s, Inc. Derivative Litig.*, 386 F. Supp. 2d 1355, 1368 n.20 (N.D. Ga. 2005); *In re Interpublic Sec. Litig.*, 2004 WL 2397190, at *9 (S.D.N.Y. 2004).

¹⁰⁷ The *Whitehall Jewellers* court applied the *Cort* Test:

Under the familiar four-part test set out in *Cort v. Ash*, an implicit private cause of action is more likely to be found when: (1) a plaintiff is part of the class for whose benefit Congress enacted the statute; (2) there is an indication of the existence of a private right based on the common tools of statutory interpretation including an examination of legislative history and the structure of the statute; (3) a remedy would be consistent with the legislative scheme; and (4) the cause of action is not one traditionally relegated to state law.

In re Whitehall Jewellers, Inc. Shareholder Derivative Litig., 2006 WL 468012, at *7 (N.D. Ill. 2006) (citing 422 U.S. 66, 78).

¹⁰⁸ *See id.* at *8.

¹⁰⁹ *In re BISYS Group Inc. Derivative Action*, 396 F. Supp. 2d at 464.

¹¹⁰ *Neer v. Pelino*, 389 F. Supp. 2d at 655 (“Because Congress explicitly created a private right of action in Section 306 and did not do so in Section 304, the natural inference is that Congress did not intend to create a private right of action in Section 304.”).

¹¹¹ *Kogan v. Robinson*, 432 F. Supp. 2d at 1082. *See also In re Whitehall Jewellers, Inc. Shareholder Derivative Litig.*, 2006 WL 468012, at *8; *Neer v. Pelino*, 389 F. Supp. 2d at 657.

¹¹² *Neer v. Pelino*, 389 F. Supp. 2d 648, 655 (E.D. Pa. 2005).

¹¹³ Tim Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 DICK. L. REV. 355, 369 (1994) (“[I]t appears that a

seven of the twelve federal circuits. As no circuit court has held that a private right of action exists,¹¹⁴ it seems to suggest that the remaining circuits, when addressing this matter of first impression, will find the “well reasoned opinion[s]” of their fellow circuit courts¹¹⁵ persuasive and will likely adopt a similar position.¹¹⁶

B. SEC’s Enforcement of Section 304: The Neglected Power Tool

It seems clear from the current judicial treatment that no private right of action exists under Section 304¹¹⁷ and the courts are reluctant to conclude otherwise without a clear congressional intent or agency interpretation.¹¹⁸

relatively high number of these shareholder class actions and derivative suits may be without merit and that the real driving force behind these suits are . . . attorneys for whom powerful incentives seem to exist to bring nonmeritorious actions . . . [resulting in] low recovery for plaintiffs [but] a high award of attorneys’ fees.”).

¹¹⁴ See *supra* note 106.

¹¹⁵ See *Neer v. Pelino*, 389 F. Supp. 2d at 655.

¹¹⁶ It should be noted that there is one case, *Om Group, Inc. v. Mooney*, which did not reach the merits of the claim, that seems to present a potential problem, but one that does not directly conflict with the issue of a private right of action. See *Om Group, Inc. v. Mooney*, No. 2:05-546, 2006 U.S. Dist. LEXIS 1446 (Jan. 11, 2006). In this case the Florida District Court, in stating “the ability to bring a disgorgement action under the Sarbanes Oxley Act is a dispute ‘arising with respect to’ the Employment Agreement, which makes it arbitrable under the Agreement” seems to be suggesting that the Arbitrator has the power to hear such a claim and decide if the claim can be brought. *Id.* at 21. The court did not rule on whether a private right of action would exist if brought in Federal Court, but it also did not prohibit the arbitrator from awarding repayment under this Section. The dicta effectively creates the possibility that an arbitrator could order a statutory remedy while a court would have no right to do so. *Id.* Since not all the federal circuits have ruled on the private right of action issue, and the issue is not clearly codified, appealing an arbitrator’s award on the basis of “manifest disregard of the law” would be potentially problematic. See Christopher R. Drahozal, *Codifying Manifest Disregard*, 8 NEV. L.J. 234, 235–36 (2007). This author would recommend adding a limitation of remedies clause to any arbitration provision which states that the arbitrator may not order forfeiture of incentive pay or bonuses under 15 U.S.C. § 7243 nor may the arbitrator order any remedy which is only available for enforcement by the SEC or another administrative agency.

¹¹⁷ Stanley Keller, *Stock Option Pricing Practices Occupy Center Stage*, American Law Institute Course of Study June 28–29, 2007, at 367 (“judicial decisions to date have held that only the SEC can enforce the compensation forfeiture provision of Section 304 of the Sarbanes-Oxley Act”). See also *infra* Part III.A.4.

¹¹⁸ *Neer v. Pelino*, 389 F. Supp. 2d at 653, 655 (stating that a court can imply a private right of action “only where it can confidently conclude Congress so intended” and to do so in this case would have required it to rewrite the statute) (citing Dept. of Env’tl. Protection Agency v. Long Island Power Auth., 30 F.3d 403, 421 (3d. Cir. 1994) (quotation and emphasis omitted)).

The judicial reasoning has firmly placed Section 304 enforcement in the hands of the SEC, and the SEC alone.¹¹⁹ Yet, to date, there have been only five suits where the SEC has even raised Section 304 forfeiture in its complaint.¹²⁰ If only the SEC can bring a cause of action for disgorgement under Section 304, there seems to be a total lack of litigation in this area.¹²¹

It is curious to see the SEC so reluctant to enforce Section 304, while so eagerly enforcing other Sarbanes-Oxley provisions.¹²² Section 304 could be a very powerful tool by creating a greater incentive for executives to ensure the transparency of disclosures, and creating an affirmative duty of executive responsibility.¹²³ However, the statute can only have this effect if it is enforced. "If corporate actors know that unethical conduct will have significant legal . . . ramifications, then they will be less inclined to engage in such conduct" and will actively seek to prevent it.¹²⁴

Looking at the record in the time period between July 1, 2002 and June 30, 2006, over 1,121 publicly traded companies filed a total of 1,786 restatements¹²⁵ "made because of financial reporting fraud and/or accounting errors."¹²⁶ This data represents the number of restatements filed since Sarbanes-Oxley went into effect,¹²⁷ and "industry observers" list the regulations of Sarbanes-Oxley as one of the prime factors that lead to the "nearly five-fold increase" in the number of restatements.¹²⁸ Based on the analysis of the GAO, it is presumed that any restatement filed that is not due to a change in accounting policy or a stock split, is due to material non-

¹¹⁹ See Welsh, *supra* note 81, at 2.

¹²⁰ See *infra* note 133.

¹²¹ See J. Mark Poerio & Crescent A. Moran, *They Can't Take It with Them: 'Clawback' Policies Hit Errant Executives where it Hurts Most*, 29 NAT'L L. J. (Col. 4) No. 27, at 2 (2007) ("The SEC has yet to pursue an action to enforce the provision of 304").

¹²² Cf. Kenneth B. Winer, *Financial Fraud and Accounting*, 1-4 Sec. Enforcement: Counseling and Defense (MB) § 4.02 (showing an increase number of enforcement actions each year).

¹²³ See *infra* Part II.B. See also *infra* note 216.

¹²⁴ Harshbarger & Jois, *supra* note 80, at 17.

¹²⁵ See Report to the Ranking Minority Member, Comm. On Banking, Housing, & Urban Affairs, U.S. Senate, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities*, GAO-06-678, at 4 (July 24, 2006 and E-Supplement) [*hereinafter* Report, *Financial Restatements*, GAO-06-678].

¹²⁶ United States Government Accountability Office, *E-Supplement to Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities*, GAO-06-678 (Issued March 5, 2007), available at <http://www.gao.gov/special.pubs/gao-06-1079sp/index.html>.

¹²⁷ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (effective July 30, 2002).

¹²⁸ Report, *Financial Restatements*, GAO-06-678, *supra* note 125, at 11-12.

compliance with the securities filing requirements.¹²⁹ The restatements gathered by the GAO were “identified as having been made because of financial reporting fraud and/or accounting errors,”¹³⁰ and are for the purposes of this discussion presumed to be the result of misconduct.¹³¹ This inference is corroborated by the growth in the number of SEC enforcement actions “involving financial fraud.”¹³² Therefore, the SEC has had over a thousand opportunities where Section 304 enforcement would have been appropriate.

However, as of December 2007, the SEC had brought Section 304 actions in only five cases.¹³³ More disturbing is that the SEC itself noted in a press release on May 31, 2007, that this was its “first time” using Section 304.¹³⁴ The counterpart statistic to this discrepancy between restatements that would trigger Section 304, and actions where 304 charges were brought, is

¹²⁹ Report, *Financial Restatements*, GAO-06-678, *supra* note 125, at 17, fig.4, n.1 (“Our database includes announced restatements that were being made to correct material misstatements of previously reported financial information. Therefore, our database excludes announcements involving stock splits, changes in accounting principles, and other restatements that were not made to correct mistakes in the application of accounting standards.”).

¹³⁰ The E-Supplement Abstract for the GAO Report (Report, *Financial Restatements*, GAO-06-678, <http://www.gao.gov/special.pubs/gao-06-1079sp/index.html>).

¹³¹ *Supra* Part III.A.1.

¹³² Report, *Financial Restatements*, GAO-06-678, *supra* note 125, at 6. “The number of SEC enforcement cases involving financial fraud and issuer reporting issues increased . . . more than . . . 130 percent” since 1998 and in 2005 “constituted the largest category of enforcement actions.” *Id.*

¹³³ SEC v. McGuire, Litig. Rel. No. 2754, 2007 WL 4270709 (Dec. 6, 2007); SEC v. Brooks, Litig. Rel. No. 20345, 2007 WL 3119762 (Oct. 25, 2007); SEC v. Schroeder, Litig. Rel. No. 20207, 2007 WL 2126402 (July 25, 2007); SEC v. Shanahan, Litig. Rel. No. 20193, 2007 WL 2011039 (July 12, 2007); SEC v. Mercury Interactive, LLC, Litig. Rel. No. 20136, 2007 WL 1574067 (May 31, 2007). Since December 2007 there have been at least two more complaints filed by the SEC seeking Section 304 forfeiture. See Complaint (No. 20710) at p. 28, SEC v. Sabhlok, Civ. Action No. 08-cv-4238 (N.D. Ca. 2008) (filed Sept. 9, 2008), available at http://www.sec.gov/litigation/complaints/2008/comp20710-sabhlok_pattison.pdf; Complaint (No. 20638) at p. 30, SEC v. Sycamore Networks, Inc., Civ. Action No. 08-cv-11166 DPW (D. Ma. 2008) (filed July 9, 2008), available at <http://www.sec.gov/litigation/complaints/2008/comp20638.pdf>.

¹³⁴ Press Release, SEC, SEC Settles with Mercury Interactive and Sues Former Mercury Officers for Stock Option Backdating and Other Fraudulent Conduct, SEC Press Rel. 2007-108 (May 31, 2007) (“The Commission’s first ever use of Section 304 of Sarbanes-Oxley—which allows the commission to seek the repayment of bonuses and stock sale profits received by CEOs and CFOs where financial results are later restated—reflects the Commission’s willingness to use all available remedies to deprive such senior officers of illicit gains.”).

the number of times the SEC has exercised its Section 304(b) exemption authority or otherwise stated that companies with restatements due to misconduct were exempt from action under Section 304. But again, the SEC seems to be ignoring Section 304. As of the end of 2007, only three no-action letters even mention Section 304,¹³⁵ and not one exemptive order mentions it.¹³⁶ All of those that do mention Section 304, do so only in reference to internal clawback provisions that the board of directors or shareholders wished to implement, and the extent it would conflict or overlap with Section 304.¹³⁷ There is a significant disparity between the number of non-exempt restatements filed that could have triggered a Section 304 action, and the number of actions where Section 304 forfeiture was actually sought.¹³⁸

The lack of enforcement is worrisome and problematic. Under the current version of the law, and the current judicial interpretations, there is nothing a private party can do to force the SEC to bring these types of actions. Consequently, the public should be able to rely on the SEC to bring these types of actions, or at least do a rudimentary investigation and issue a no-action letter or exempt the CEO and CFO from potential charges. To fail to sufficiently pursue actions under Section 304 will encourage investors to be distrustful of the SEC and large corporations, by reinforcing the public perception that someone in the company can violate the securities laws. Such violations result in a huge loss to investors when the company is forced to restate, and yet the person trusted by the public to prevent such misconduct,¹³⁹ i.e. the CEO or CFO, will still leave at the end of the day with

¹³⁵ Home Depot, Inc., SEC No-Action Letter, 2007 SEC No-Act. LEXIS 318, at * 19 (Mar. 7, 2007); Bristol-Myers Squibb Co., SEC No-Action Letter, 2005 SEC No-Act. LEXIS 251, at *4, 17–18, 22, 25, 29–30 (Feb. 17, 2005); Interpretive Guidance on Restatements for Errors in Accounting for Stock Option Grants, SEC No-Action Letter, 2007 WL 287319, at *4 (Jan. 16, 2007). *Cf.* Exxon Mobil Corp., SEC No-Action Letter, 2008 SEC No-Act. LEXIS 27 (Jan. 3, 2008) (does not specifically mention a 304 cause of action but discusses recoupment of executive compensation when earnings were based on inaccurate financial data).

¹³⁶ See SEC, *Exemptive Orders Archive*, (2003–2007), available at <http://www.sec.gov/rules/exorders.shtml>.

¹³⁷ For an example of such a discussion see the Home Depot, Inc., SEC No-Action Letter, 2007 WL 754967 (Mar. 7, 2007). No exemptive orders mention Section 304 at all.

¹³⁸ Granted, the SEC has the sole authority to decide to bring an action, but their use of enforcement provisions as motivation to act preventatively seem to be significantly under-represented in the total number of enforcement actions. For a further discussion of why the SEC might be avoiding enforcement see *infra* Part IV.

¹³⁹ See 148 CONG. REC. H5462, H5463 (July 25, 2002) (statement of Rep. Baker discussing Conf. Rep. on H.R. 3763) (“A corporate executive takes capital from individual investors, hard-working investors saving for their first home, their child’s education or their retirement, and has a fiduciary responsibility to manage that money for their mutual good.”).

his cushy perks totally untouched.¹⁴⁰ Lazy enforcement undermines the incentives of the Section, and decreases the faith of the general public in the efforts of companies and the SEC to ensure financial reporting accuracy.¹⁴¹ Five years of unanswered, misconduct-triggered restatements cannot be remedied by five actions and the absence of definitive agency guidance.

C. Five Cases in Year Five: What They Tell Us

While five counts in five cases¹⁴² can hardly be referred to as a trend, both the sudden willingness to bring these causes of action and the similarities between these cases are potentially suggestive of the tone of future enforcement. When one looks at the actual complaints filed in these five cases, one can begin to see an implicit understanding of the claim and its elements. Unfortunately, if one limits the scope of enforcement actions to only scenarios similar to these cases, the potential power and effect of Section 304 becomes severely stunted.

The complaints, to the extent that they are indicative of a common understanding of the action, do add clarity to several disputed issues. Most important is the presence of an SEC complaint in the first place, ruling out the possibility that the SEC believed this to be only a private right of action. Additionally, the prayer for relief in each case designates separate counts for “disgorgement of ill-gotten gains” and “repayment of bonuses and compensation,” demonstrating that the SEC believes these to be different types of relief. Presumably, this is to differentiate the purpose behind Section 304 from those established understandings of the purposes for disgorgement.¹⁴³ Two of the five complaints include paragraphs of specific alleged facts that appear to be directed at the elements of the Section 304

¹⁴⁰ See Carrie Johnson & Ben White, *Opportunity for Corporate Fraud has Shrunk—but It’s Still There*, WASH. POST, Jan. 26, 2006, at D1 (“Executives collected more than \$400 million in salary and bonuses but denied knowing about fraud on their watch.”).

¹⁴¹ Stephen Taub, *Restatements Surged in 2005, Says Study: The Total Number of 2005 Restatements Works Out to One Restatement for Every 12 Public Companies*, CFO MAGAZINE, Mar. 3, 2006, available at <http://www.cfo.com/article.cfm/5591688> (“When so many companies produce inaccurate financial statements, it seriously calls into question the quality of information that investors relied upon to make capital-allocation decisions,” noted the report. “Investors need unbiased, competently prepared financial statements to make these decisions efficiently.”).

¹⁴² See *supra* note 133.

¹⁴³ Complaint (No. 20193) at p. 23, SEC v. Shanahan, Civ. Action No. 4:07-cv-1262 (E.D. Mo. 2007) (filed July 12, 2007), available at <http://www.sec.gov/litigation/complaints/2007/comp20193.pdf> (compare Count III with Count VI). See also discussion of disgorgement, *supra* Part II.B.

violation specifically.¹⁴⁴ In three of these cases the SEC seems to suggest that a restatement is required when financial statements “by virtue of . . . misconduct, failed to [be] . . . in conformity with GAAP.”¹⁴⁵ The language also evidences a clear policy understanding that where bonuses and gains are derivative of the financial performance of the company, and that performance was artificially inflated, the defendant should not get to keep those gains.¹⁴⁶

There is some evidence that these claims are typically brought in cases where the CEO or CFO has participated in some action that is particularly shocking to the principles of Sarbanes-Oxley¹⁴⁷ and, in these five cases, knowingly or deliberately.¹⁴⁸ Additionally, in each case the CEO has been the alleged driving force behind the misconduct perpetrated against the issuer, and the defendant actively disregarded warnings and sanctions concerning their illicit conduct.¹⁴⁹ It is clear that Section 304 is intended at a

¹⁴⁴ Complaint (No. 20387) at ¶ 23, SEC v. McGuire, Civ. Action No. 07-CV-4779-JMR/FLN (D. Minn. 2007) (filed Dec. 6, 2007), *available at* <http://www.sec.gov/litigation/complaints/2007/comp20387.pdf>; Complaint (No. 20193) at ¶ 50, SEC v. Shanahan, *supra* note 143.

¹⁴⁵ Complaint (No. 20136) at ¶ 116, SEC v. Mercury Interactive, LLC (f/k/a Mercury Interactive Corporation), Amnon Landan, Sharlene Abrams, Douglas Smith, and Susan Skaer, No. 07-2822 (RS) (N.D. Cal. 2007) (filed May 31, 2007), *available at* <http://www.sec.gov/litigation/complaints/2007/comp20136.pdf>. *See also id.* at ¶¶ 7–8 & 81; Complaint (No. 20387) at ¶ 23, SEC v. McGuire, *supra* note 144; Complaint (No. 20193) at ¶ 50, SEC v. Shanahan, *supra* note 143. *But, see*, Coffee, Jr., *supra* note 61, at 343 (“This concept of ‘fair presentation’ is not limited by any reference to GAAP, and compliance with GAAP is clearly not dispositive of whether the issuer has provided a ‘fair presentation.’ Instead, the standard seems to intend that the issuer provide full and fair disclosure in the form of a holistic picture of the company that reveals all material financial weaknesses, even if their disclosure were not required by GAAP.”).

¹⁴⁶ Complaint (No. 20136) at ¶ 81, SEC v. Mercury Interactive, *supra* note 145 (“profits through the sale of the shares they acquired through their exercises of Mercury options, which were sold into the market at times when the price of Mercury’s stock was inflated by the fraud . . . [and] bonuses [while] largely discretionary, their award was at least in part related to the financial performance of the company during the period of the fraud, which resulted in material GAAP expenses being omitted from the company’s financial reports.”).

¹⁴⁷ The actions in the cases are deliberate attempts at deception, directly counter to transparency and disclosure. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 745–747 (aiming to “protect investors by improving the accuracy and reliability of corporate disclosures”).

¹⁴⁸ The named party in each complaint is also being charged with 17(a) actions and 10(b) and 13(b)(2) aiding and abetting actions, requiring a “knowing” or “reckless” violation. *See supra* notes 144–146; *see infra* note 150.

¹⁴⁹ *See* Complaint (No. 20345) at ¶ 29, SEC v. Brooks, Civ. Action No. 07-61526-CIV-Altonaga/Turnoff (S.D. Fla. 2007) (filed Oct. 25, 2007), *available at* <http://www.sec.gov/litigation/complaints/2007/comp20345.pdf> (alleging that Brooks “largely ignored the auditors’ concerns”); Complaint (No. 20207) at ¶ 1, SEC v.

minimum to prevent CEO's from benefiting from their own misconduct¹⁵⁰ and to act as the catchall penalty for the compensation and funds that the other actions did not reach. However, the complaints that do specifically address misconduct leave the question of the causal link open.¹⁵¹ It is conceivable that the use of Section 304 is no more relevant than any other penalty on the SEC's laundry list, and was tacked onto the complaint in order to throw the proverbial book at the defendant. If any enforcement trend is to be gleaned from these five cases, it should be viewed as a floor, not as a ceiling. In other words, just because the SEC knows it has enough evidence to make out the Section 304 cause of action in these situations, does not mean that a less clear causal connection to the misconduct, such as recklessness or negligence, could not also impose liability on the CEO and CFO.

In looking at the history and the case law surrounding Section 304, it seems clear that its intent was to impose a penalty for failing to search out all forms of corporate misconduct.¹⁵² This appears to provide the correct incentives for executives to ensure the corporate health of the organizations, and logically seems tied to their compensation for carrying out this task.¹⁵³ Additionally, the fact that all the courts that have considered the issue have found that no private right of action exists suggests that the SEC was selected as the enforcement agency to impose upon the statute some level of restraint,

Schroeder, No. C07 3798 JW (N.D. Cal. 2007) (filed July 25, 2007), *available at* <http://www.sec.gov/litigation/complaints/2007/comp20207-schroeder.pdf> ("Schroeder continued to engage in this practice even after being specifically instructed by Company counsel that retroactively selecting grant dates without adequate disclosure was improper.").

¹⁵⁰ Complaint (No. 20193) at ¶ 7, SEC v. Shanahan, *supra* note 143 ("Shanahan personally received ill-gotten gains, including \$8,916,562 in backdated profits, from his participation in this scheme."). It seems that the SEC is at least willing to take enough action "to prevent CEOs or CFOs from making large profits by selling company stock, or receiving company bonuses, while . . . misleading the public and regulators about the poor health of the company." S. REP. NO. 107-205, at 26 (2002).

¹⁵¹ See Complaint (No. 20193) at ¶ 50, SEC v. Shanahan, *supra* note 143 ("The requirement to restate resulted from Shanahan's and others' misconduct in connection with the granting of stock options.").

¹⁵² Nelson, *supra* note 59, at 1167 (Stating that Sarbanes-Oxley helped to pierce the veil "in order to impose liability on directors, officers, and employees for breaching their fiduciary duty . . . [and] prior fundamental obligations to guarantee accurate financial reporting.").

¹⁵³ Some have commented that ensuring financial accuracy is becoming an increased part of the CFO's general job description. See Don Durfee, *Pay Up: With Finance Talent in High Demand, Companies are Boosting Compensation—And Making Some Demands of Their Own*, CFO MAGAZINE, Nov. 1, 2006 ("compensation for a growing number of CFOs is evolving: they're making more, but boards are also making them work harder to achieve the mega pay levels that became common in the 1990s").

presuming that the SEC would balance the benefit and necessity of bringing actions under Section 304 against the potential risks and financial burdens.¹⁵⁴ To see the enforcement of such a strong provision barely used seems to indicate either a systemic problem or a conscious policy determination by the SEC for not bringing these causes of action.

IV. POSSIBLE REASONS WHY THE SEC IS NOT PURSUING ACTIONS UNDER SECTION 304

Part IV discusses several theories as to why the SEC is not bringing enforcement actions under Section 304. The first theory as to why the SEC is not bringing these actions is that the incentives of the statute have properly functioned to put a stop to all corporate misconduct or the CEO and CFO have successfully found all the misconduct. Another apparent reason is that due to the ambiguity and confusion surrounding the provision the SEC does not know what situations are appropriate, or feels that many situations are inappropriate for bringing such actions, so it often chose not to pursue this particular cause of action.¹⁵⁵ Another systemic reason why the SEC is failing to bring these actions may be because the provision is either obsolete or ineffective. With so many remedies available for use on violators of the Securities Exchange Act of 1934, Section 304 may not have the deterrent effect it was designed to have.¹⁵⁶ Clearly, if the same violation could allow for treble damages or criminal sanctions, the loss of compensation would be superseded by this. Alternatively, so many similar damages may be available in private causes of action and derivative suits that the targeted funds under 304 may already have been disgorged and returned to the issuer. Therefore, bringing an action under 304 would be futile.

¹⁵⁴ Cf. Report, *Financial Restatements*, GAO-06-678, *supra* note 125, at 45 (“SEC’s view of the appropriateness of the penalty against corporations versus the individuals who actually commit the violations is to be based on two considerations[. . . whether the corporation received a direct benefit as a result of the violations . . . [and] the degree to which the penalty will recompensate or further harm injured shareholders.”).

¹⁵⁵ The list of factors given for assessing actions that impose civil penalties focus on “the extent of the injury to innocent parties” and “the level of intent on the part of perpetrators.” This consideration of injury and intent seems to be in direct conflict with the current understanding of “misconduct” as requiring negligent liability as opposed to direct or intentional liability. Report, *Financial Restatements*, GAO-06-678, *supra* note 125, at 45. This goes against the previously proposed “inattentiveness” interpretation. See *supra* Part III.A.1.

¹⁵⁶ Dawes & Johnson, *supra* note 30, at 120 (“Recent disgorgement cases brought by SEC suggest that individuals who actively engage in misconduct are the typical targets of SEC’s prosecutorial might.”).

There are also several policy justifications as to why the SEC might actively be choosing to not bring causes of action under Section 304. It might feel that the market is self-regulating to correct this problem through contractual “clawback” provisions or reputation value, and that no additional government regulation is needed to root out misconduct.¹⁵⁷ The SEC might have an economic disincentive to pursue these causes of action, finding it excessive and that the imposition of these causes of action will do significant harm to the companies and the market as a whole.¹⁵⁸ Finally, the most likely explanation for the SEC’s lack of action is that the SEC is signaling an increase in enforcement of Section 304 in the upcoming years.¹⁵⁹ The SEC is likely conscious of the high costs of complying with many of the procedures required by Sarbanes-Oxley and has actively chosen to give the market a few years to set up these procedures and find the past misconduct before imposing a harsh punishment.¹⁶⁰ This theory best explains the sudden action in 2007, when no enforcement was previously seen.¹⁶¹ The SEC is signaling to the market that companies have had their chance to adjust to Sarbanes-Oxley; if they have not found the misconduct by now, the SEC is going to nail them for it. This Part will analyze the likelihood of each of these possible reasons in turn.

A. Sarbanes-Oxley Was a Total Success and There Is No More Corporate Misconduct

The first potential explanation for the lack of enforcement actions brought under Section 304 could be that there is in fact no need to bring these actions. Such a situation would arise in the event that no restatements are filed “due to misconduct” and nothing has triggered the need for enforcement.¹⁶² This reason is addressed first because it is the theory that is

¹⁵⁷ See Poerio & Moran, *supra* note 121 (“institutional investors are pressing mightily for restatement clawbacks”).

¹⁵⁸ See BUTLER & RIBSTEIN, *supra* note 9, at 54 (discussing the rate at which companies are going dark, or going private).

¹⁵⁹ See *infra* Part IV.F. This concept originated in a discussion with Paul Rose, Assistant Professor of Law at Moritz College of Law.

¹⁶⁰ Harshbarger & Jois, *supra* note 80, at 18 (“Nearly five years after SOX, companies are still restating earnings on a regular basis, uncovering earlier misconduct.”).

¹⁶¹ Press Release, Sec. & Exch. Comm’n, SEC Settles with Mercury Interactive and Sues Former Mercury Officers for Stock Option Backdating and Other Fraudulent Conduct, SEC Press Rel. No. 2007-108 (May 31, 2007), *available at* <http://www.sec.gov/news/press/2007/2007-108.htm>.

¹⁶² Since the term “misconduct” is so poorly defined it could be that nothing is falling within the definition of the term. See *supra* Part III.A.1.

most easily dismissed. While most of the legal community believes that Sarbanes-Oxley has the potential to end corporate misconduct, or is a major step towards effective fraud prevention and securities law enforcement, few believe that corporate misconduct has in fact ceased.¹⁶³ The sheer number of restatements filed since Sarbanes-Oxley's enactment in 2002 is strong evidence that corporate misconduct is being uncovered every day.¹⁶⁴ While this is positive evidence that more misconduct is being identified by the new auditing procedures, it is also clear that those same provisions have not yet reached the level of *fraud prevention*.¹⁶⁵ However, if one is to follow the congressional mandate under Section 304, catching the misconduct after the filing of a financial report is not enough to protect the incentive pay of the CEO and CFO, whose job it was to catch the misconduct before the filing of the financial report, in order that the public would not have been misled as to the state of the company for even a day.¹⁶⁶ Given the expansion of the SEC enforcement efforts over the past few years¹⁶⁷ it is doubtful that even the SEC would argue that Sarbanes-Oxley has managed to catch all past and present corporate misconduct.

B. SEC is Unsure of Its Authority Under Section 304

The second reason the SEC might be hesitant in enforcing Section 304 is that it is unclear of its authority or is afraid to act beyond the scope of the provision.¹⁶⁸ While it has been established that there is significant ambiguity in the statutory text as drafted,¹⁶⁹ it is clearly within the legislative authority

¹⁶³ See Johnson & White, *supra* note 140, at D1; John W. Schoen, *Corporate Fraud Alive and Well in the U.S.: Despite Enron Verdict, Accounting Reforms, White-Collar Crime Thriving*, MSNBC (May 25, 2006), <http://www.msnbc.msn.com/id/12762573/> ("U.S. losses from fraud rose to an estimated \$638 billion in 2005 — up from \$600 billion in 2002.").

¹⁶⁴ See Report, *Financial Restatements*, GAO-06-678, *supra* note 125, at 6.

¹⁶⁵ Harshbarger & Jois, *supra* note 80, at 18.

¹⁶⁶ See Johnson & White, *supra* note 140, at D1.

¹⁶⁷ See U.S. CHAMBER OF COMMERCE, REPORT ON THE CURRENT ENFORCEMENT PROGRAM OF THE SECURITIES AND EXCHANGE COMMISSION 12 (2006) [hereinafter CURRENT ENFORCEMENT], available at <http://www.uschamber.com/publications/reports/0603sec.htm> (click link to pdf) (concluding that "the SEC's enforcement program has taken on an increasingly punitive tone" and major expansion effort).

¹⁶⁸ Scholars have noted that use of Section 304 might face constitutional challenges for "arbitrariness" because the amounts required to be repaid were not "causally linked to the misconduct;" if the incentive pay was calculated on the correctly restated amount they would still be entitled to some portion of the pay already received. Fraidin et al., *supra* note 37, at 61.

¹⁶⁹ *Supra* Part III.A.

of the SEC to issue interpretive guidance and regulations.¹⁷⁰ One could attempt to draw interpretive guidance from their chosen enforcement actions, and conclude that the SEC is implicitly imposing a personal culpability requirement, but to do this would give too much precedential value to such a small number of enforcement actions.¹⁷¹ When considering precedential effect, one should consider that the SEC has limited resources so it is not surprising that it may target its greatest weapons at the most heinous violations, or may only have the budget to pursue the most egregious cases.¹⁷² However, the SEC should be extremely cautious not to accidentally set a precedent of only enforcing it in such cases, because to do so would artificially restrict its power and the deterrent effect Congress intended the provision to have.

While it seems possible that the SEC could have believed at the time of enactment that there was a private right of action under Section 304, it seems unlikely that it would persist in that position given the utter lack of commentary to that effect and the unanimous view of the Federal Courts that have held to the contrary.¹⁷³ Although a perceived lack of clarity or authority might have been a legitimate justification when the Act was first passed, this reason seems to lack credible weight as an explanation for not bringing actions under Section 304, especially in the current enforcement regime.¹⁷⁴

A slightly more likely explanation for the SEC's ambivalent enforcement is that it is unclear as to the elements of the claim and which factual scenarios would fall within its statutory authority. The abundance of ambiguity in the statutory text is clear support for this proposition.¹⁷⁵ In addition to the argument over the meaning of misconduct, a debate exists over the term "required,"¹⁷⁶ as well as when a restatement is required to be filed (suggesting a mandatory action) versus when a restatement is common or

¹⁷⁰ Sarbanes-Oxley Act of 2002 § 3(a), 15 U.S.C. § 7202(a) (2006) ("The Commission shall promulgate such rules and regulations, as may be necessary or appropriate . . . in furtherance of this Act.").

¹⁷¹ It would not be prudent to determine precedent based on only five cases. See *supra* Part III.C. Cf. David Phillips, *Sarbanes-Oxley Act—Fraud Deterrence with Teeth?*, SEEKING ALPHA, (May 28, 2006), available at <http://seekingalpha.com/article/11286-sarbanes-oxley-act-fraud-deterrence-with-teeth-q-gmst-tyc-cd> ("[W]e are still looking to the SEC to find a 'test case' on which to cut its teeth.").

¹⁷² See Bloomenthal, *supra* note 46, at *11.

¹⁷³ See *supra* Part III.A.4.

¹⁷⁴ CURRENT ENFORCEMENT, *supra* note 167, at 18–23.

¹⁷⁵ See Coffee Jr., *supra* note 61, at 337 n.107 ("Ambiguities abound here."). See also *supra* Part III.A.

¹⁷⁶ Sarbanes-Oxley Act of 2002 § 304(a), 15 U.S.C. § 7243(a) (2006) ("If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer . . . executive officer . . . shall reimburse the issuer[.]").

filed at the discretion of the issuer.¹⁷⁷ While restatements have been filed “due to misconduct” within the company, no restatement was actually “required” to be filed.¹⁷⁸ The SEC has provided little interpretive guidance as to when a restatement is “required” to be filed, rather than recommended or necessitated. The Securities Exchange Act of 1934 directive on restatements of 10-K or 10-Q financial reports states that:

If any material change occurs in the facts set forth in the statements . . . filed with the Commission, an amendment . . . *shall* be filed with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.¹⁷⁹

Given recent SEC attention to compliance with Generally Accepted Accounting Principles (GAAP) requirements, it is likely that “a restatement is ‘required’ when the restatement is necessary for an issuer’s auditors to issue their opinion on the financial statements.”¹⁸⁰ But, it should not be forgotten that the SEC has the power to clarify its own authority or understanding through regulations and interpretive guidance.¹⁸¹ It seems clear that the SEC has the power to clarify the Section 304 cause of action and eliminate ambiguity, which begs the question: why then is there not one regulation addressing the ambiguities in 304?¹⁸²

¹⁷⁷ The SEC can request information or one can voluntarily choose to provide it, so the use of the phrase “require” could be read to mean only in those instances where the SEC has actually issued a subpoena or taken some other administrative action. *See* U.S. Securities and Exchange Commission, *Notice on Supplying Information Voluntarily*, SEC 2405 (7-96), <http://www.sec.gov/about/forms/sec2405.pdf> (last visited Oct. 5, 2008).

¹⁷⁸ Fraidin et al., *supra* note 37, at 56 (presenting two different interpretations of “required” and suggesting that it might create a rebuttable presumption, where the company would have to prove that the restatement was in fact “discretionary”). *See also* Alston & Bird LLP Securities Law Advisory, *Sarbanes-Oxley Requires Disgorgement of Bonuses and Profits in the Event of a Financial Reporting Restatement*, (Sept. 9, 2002), available at <http://www.realcorporatelawyer.com/pdfs/ab090902.pdf> (last visited Oct. 3, 2008).

¹⁷⁹ Securities Exchange Act of 1934 § 13(d)(2), 15 U.S.C. § 78m(d)(2) (2002) (emphasis added). Here the argument would be that any material change makes a restatement required.

¹⁸⁰ Eigenbrodt, *supra* note 81, at 2. *But see* Coffee, Jr., *supra* note 59, at 344 (“[i]n interpreting this new [certification] requirement, the SEC has cited *Simon* for the proposition that ‘[p]resenting financial information in conformity with generally accepted accounting principles may not necessarily satisfy obligations under the antifraud provision of the federal securities laws.’”).

¹⁸¹ *See* Sarbanes-Oxley Act of 2002 § 3(a), 15 U.S.C. § 7202(a) (2006).

¹⁸² One could argue that the SEC is purposefully vague to allow the law to have the greatest deterrent effect. However, to enforce the provision without clarifying the extent and elements of the cause of action, the SEC is risking an unintended precedent, and in

C. Enforcement Actions Under Section 304 Are a Futile Waste of Time

It is possible that the SEC has chosen not to pursue Section 304 enforcement in the past six years because the potentially recoverable salary would already have been recovered through actions brought under other statutory authority. The SEC is already able to disgorge “ill gotten gains” which would include any profits from fraud, misconduct, or knowledge of such.¹⁸³ Punishment for securities violations is significantly aided by private actions in the form of derivative suits, such as a 10b-5 action,¹⁸⁴ which could also target any gains or profits made from stock sales or incentive pay.¹⁸⁵ Additionally, despite possessing an element of scienter, a Rule 10b-5 action would target the causal connection between the CEO and the misleading statement, and would successfully disgorge much of the same funds as Section 304.¹⁸⁶ Because these actions target the same source for damages that Section 304 would target, it is possible that those bonuses, incentives, and options have already been disgorged; with that, the SEC perceives no utility in strict enforcement under Section 304.¹⁸⁷

Alternatively, the SEC could deem that other provisions—such as Section 906, which imposes criminal sanctions and carries a maximum sentence of 20 years in jail,¹⁸⁸ or Section 807, with a maximum of a 25 year

the interim, is only increasing the market’s anxiety by not providing adequate notice of what constitutes a violation.

¹⁸³ Winer, *supra* note 122, at § 18.10 (describing the purpose of disgorgement as being causally connected to unjust enrichment).

¹⁸⁴ 17 C.F.R. § 240.10b-5 (2008).

¹⁸⁵ The SEC’s enforcement efforts can be greatly aided by the existence of derivative suits: the SEC does not have the money or staff to vindicate the rights of every investor. See Shannon Rose Selden, *(Self-)Policing the Market: Congress’s Flawed Approach to Securities Law Reform*, 33 J. LEGIS. 57, 73 (2006) (“[P]rivate securities class actions can complement SEC enforcement actions.”) (citations omitted).

¹⁸⁶ See 17 C.F.R. § 240.10b-5.

¹⁸⁷ The SEC stated, “Under the terms of the settlement, McGuire’s disgorgement plus prejudgment interest and his Section 304 reimbursement would be deemed satisfied by his return to UnitedHealth of approximately \$600 million in cash and . . . options pursuant to the terms of his separate settlement with the company . . . announced today, resolving employment claims and shareholder derivative lawsuits filed against McGuire in state and federal courts[.]” *Former United Health Group CEO/Chairman Settles Stock Options Backdating Case for \$468 Million*, SEC v. McGuire, Litig. Rel. No. 2754, 2007 WL 4270709 (2007), available at <http://www.sec.gov/litigation/litreleases/2007/lr20387.htm> (last modified Dec. 6, 2007).

¹⁸⁸ Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C. § 1350 (2006). See also WILLIAM E. KNEEPER & DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* § 13.14, 13–106 (7th ed. 2002).

sentence¹⁸⁹—are far greater deterrents than threatening a director's bonus.¹⁹⁰ However, this particular section places a cap on the monetary recovery at five million dollars, and the potential penalty might not seem *as real* as a forfeiture of personal compensation would seem. Section 304 is an additional means of shifting the risk of non-compliance onto the CEO.¹⁹¹ If the SEC were to enforce this provision as proposed,¹⁹² it would represent a strong method for countering the current incentives for executives to have a "low commitment to legal compliance," thereby adding significant incentives for the SEC to bring additional enforcement actions.¹⁹³

D. SEC Believes the Market Will Self-Regulate and Therefore Does Not Need to Act

The possibility exists that the SEC is refraining from action in order to give the internal structures of the company time to put in place self-protections from fraud.¹⁹⁴ There is some evidence in the last six years that companies are amending bylaws to add incentive compensation "clawback" policies in order to create a "carefully focused deterrent"¹⁹⁵ to prevent "management benefitting from unsound financial statement[s.]"¹⁹⁶ The SEC does not choose to interfere with the implementation of these policies, unless the proposed policy is challenged by the company as vague.¹⁹⁷ For the most part, the SEC appears to be looking for companies to explicitly state how their internal "clawback" policy will interact with the operation of

¹⁸⁹ Sarbanes-Oxley Act of 2002 § 807, 18 U.S.C. § 1348 (2006). *See also* KNEEPER & BAILEY, *supra* note 188, at § 13.14, 13-112.

¹⁹⁰ Schoen, *supra* note 163 ("Fines and settlements now regularly top \$100 million").

¹⁹¹ *See* Di Lorenzo, *supra* note 10, at 786.

¹⁹² *See supra* Part III.A.

¹⁹³ Di Lorenzo, *supra* note 10, at 788-89.

¹⁹⁴ GCI Financial, *SEC Not Compelled to Enforce "Clawback,"* FINANZNACHRICHTEN.DE, Oct. 6, 2006, <http://www.finanznachrichten.de/nachrichten-2006-06/artikel-550256.asp> (last visited Oct. 5, 2008) ("A smattering of companies have . . . begun voluntarily writing their own in-house clawback policies in the event of future restatements . . .").

¹⁹⁵ Poerio & Moran, *supra* note 121, at 2.

¹⁹⁶ Nelson, *supra* note 59, at 1181.

¹⁹⁷ Bristol-Myers Squibb Co., SEC No-Action Letter, 2005 WL 415667, at *4 (Feb. 17, 2005) ("[I]t is unclear how the proposed policy would relate to the Company's responsibilities under Section 304[.]").

Section 304.¹⁹⁸ Such a treatment of the regulation is consistent with a view of the Section as a default provision, allowing companies to potentially expand on the scope of this provision. Or, it could be merely due to the fact that the SEC is unsure of the extent of its enforcement capability—so it wants to see a more explicit policy statement, such as: “following a restatement of the Company’s financial statements, the Company shall recover any compensation received by the CEO and CFO that is required to be recovered by Section 304 of Sarbanes-Oxley Act of 2002.”¹⁹⁹ Because the SEC usually enforces policies with an eye towards the harm to the investors and “the presence or lack of remedial steps by the corporation,”²⁰⁰ it is possible that the SEC is waiting for the market, and potentially company shareholders, to voice outrage at the retention of incentive pay in such situations and take enough action internally to make Section 304 assume the role of a default,²⁰¹ rather than the only means of targeting the failure to discover internal misconduct. This is truly the free market ideal that if the stakeholders, whom the CEO and CFO report to, are bothered by the level to which these parties are monitoring the company, let them take action to effect such a change internally.²⁰²

E. SEC is Implicitly Exempting Companies Because It Believes Enforcement Creates the Wrong Outcomes

The SEC has an acute awareness of the delicate balance of the financial market, and a potential reason it might be avoiding active enforcement is the

¹⁹⁸ *Id.* at *2. By choosing to take No-Action the SEC appears to be agreeing with the Company’s assessment that the proposal lacks clarity on the breadth of the interaction with Section 304. *Id.* at *13.

¹⁹⁹ Home Depot, Inc., SEC No-Action Letter, 2007 WL 754967, at *8 (Mar. 7, 2007) (SEC found the proposal sound and did not recommend exclusion from proxy material).

²⁰⁰ Report, *Financial Restatements*, GAO-06-678, *supra* note 125, at 45.

²⁰¹ Lucian A. Bebchuk & Assaf Hamdani, Symposium, *Litigation Reform Since the PSLRA: A Ten-Year Retrospective: Panel Three: Sarbanes-Oxley Governance Issues: Federal Corporate Law: Lessons From History*, 106 COLUM. L. REV. 1793, 1809–10 (2006). “Stock exchanges have also moved to require greater scrutiny of executive compensation arrangements. In 2003, the SEC approved Nasdaq and NYSE listing rules that require shareholder approval of equity compensation plans.” *Id.* at 1810.

²⁰² Incidentally, this could be a developing area to watch in the future, because it is very telling about a company’s corporate governance and their level of integrity and transparency, if there is widespread resistance to even the most tame type of “clawback” policy (i.e. those where if the CEO defrauds the company the issuer is entitled to repayment of bonuses and incentive pay) which does not approach the level of “clawback” mandated by Section 304. *See* Ramirez, *supra* note 3, at 337–38 (discussing executive compensation as the “canary in the coal mine”).

fear of creating poor incentives through over-regulating which would operate contrary to its objectives. The goal of the Act is to create transparency,²⁰³ but potential results of such a high penalty for restatement could be incentives to avoid restatements, to take additional risks or to simply to leave the market.²⁰⁴ There is also a fear of upsetting the delicate balance between the different facets of the business community.²⁰⁵

Because there is currently little to no information on the extent of conduct that might trigger liability, the SEC could have a substantial fear of creating an incentive to deceive the public and to not issue a restatement when misconduct is discovered.²⁰⁶ Those seeking to avoid the potential misconduct might engage in a system of excessive surveillance,²⁰⁷ disproportionately dedicating their time to monitoring tasks and not development tasks.²⁰⁸ However, there seems to be significant evidence that the new enforcement regime has little concern for the significantly increased

²⁰³ Sarbanes-Oxley Act of 2002 § 3, 15 U.S.C. § 7201 (2006). *See also* Henry M. Paulson, Jr., *The Key Test of Accurate Financial Reporting is Trust*, FINANCIAL TIMES, May 17, 2007, available at <http://www.treasury.gov/press/releases/hp407.htm> ("Accurate and transparent financial reporting is vital to the integrity of our capital markets and the strength of the US economy.").

²⁰⁴ Di Lorenzo, *supra* note 10, at 793–94 ("Overall, the law's vague mandate to the securities industry . . . generates denial rather than compliance").

²⁰⁵ *See* Securities and Exchange Commission, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.sec.gov/about/whatwedo.shtml> ("[A]ll of the SEC's actions must be taken with an eye toward promoting the capital formation that is necessary to sustain economic growth.").

²⁰⁶ Fraidin et al., *supra* note 37, at 56 (discussing that a "consequence of greater enforcement of Section 304, is that it may create incentives for CEOs and CFOs *not* to restate financial results.").

²⁰⁷ WILD, *supra* note 60, at § 1:152 ("Officers and directors often question securities counsel about the penalties for noncompliance . . . to justify in their own minds the time, aggravation, and expense involved in the preparation of these documents.").

²⁰⁸ It seems to render the audit and compliance procedures meaningless if they cannot blame someone else for their agent's failure to catch the fraud. Many argue the wisdom of the extensive audit procedures and requirements, but if the directors and officers know that they have to trust the information and results presented in those reports, they will have a strong incentive to ensure that the internal control systems are 100% accurate, which aligns their goals with those of potential shareholders for complete information.

cost of compliance and extensive redundancy of tasks,²⁰⁹ despite the outrage of the business community.²¹⁰

The alternative for those more honest and risk averse officers is to either leave the company or move to a company where they would not be subjected to such a high risk of forfeiture.²¹¹ In addition to the potential loss of executive talent, heavy enforcement could have the counter-productive side effects of companies “going dark,” or no longer maintaining their status as publicly traded companies to avoid the burdens of being Sarbanes-Oxley compliant.²¹² The result in either circumstance would be to remove the most qualified executives from filling those positions where they would be most likely to protect public investors against misconduct.

The SEC might also fear disruption of the market’s own controls for regulating. Some might argue that it is the role of director and officer insurance (D & O insurance) to offset this risk.²¹³ In this scenario, the resulting effectiveness of D & O insurance would depend entirely on the willingness of the insurance companies to assume the risk of a restatement.²¹⁴ This is probably less of a concern than under other provisions, since under Section 304 the price of the risk is easily determined,

²⁰⁹ Carney, *supra* note 86, at 151 (“These figures understate the real costs of compliance. . . . [I]n most cases they do not mention, much less quantify, the opportunity cost of executive time.”).

²¹⁰ See Johnson & White, *supra* note 140, at D1 (“Jeffrey Stone . . . said some new rules, especially one that requires a company . . . to examine financial controls, impose heavy costs ‘that far outstrip the protections that are afforded.’”).

²¹¹ McCann, *supra* note 90 (“[T]he job of such a CFO is getting bigger and harder at the same time the risk inherent in the position is rising. That results in more departures, both voluntary and forced . . . The increased regulatory demands that were triggered by Sarbanes-Oxley certainly have influenced some of those decisions. ‘The workload has gone up 20 to 25 percent just because of the new regulation’ . . .”).

²¹² Carney, *supra* note 86, at 150 (A study showed “[a]ggregate SEC compliance costs were \$12.2 million, or nearly fifty-one percent of total profits. When costs of compliance reach this level, it is indeed time for a firm to exit public markets.”). Cf. Nelson, *supra* note 59, at 1176, 1189–93 (companies might make this shift because “the Act does not apply to private companies”). Some have even suggested that going dark might increase executive’s incentives for misconduct. See Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703, 743–44 (2007) (“When companies go private, there is a stark conflict of interest. . . . Managers of these companies frequently use accounting gimmicks to artificially depress reported performance just before taking the company private in an effort to reduce the purchase price.”).

²¹³ Carolyn Said, *Who Pays Mounting Legal Bills? Insurers May Cover Directors, Execs—For Now*, S.F. CHRON., Oct. 20, 2006, at D1 (“Major corporations pay hefty premiums for D&O insurance that indemnifies their top executives . . . from liability for alleged wrongful acts committed on their watch.”).

²¹⁴ Dawes & Sorrell, *supra* note 54, at 6–7.

suggesting that D & O insurance might cover Section 304 violations, but at an increase over the already high premium.²¹⁵ Unfortunately, if such coverage existed it would greatly reduce the incentive of the CEO to take an active role in monitoring misconduct,²¹⁶ and therefore seem to undermine the public policy of drafting the statute.²¹⁷ Alternatively, insurance companies are likely to impose a policy exclusion of coverage based on fraud or actual knowledge or involvement.²¹⁸ Through private market incentives, an exclusion would add the personal culpability requirement that some feel is missing from the statutory text.²¹⁹

Finally, companies might adjust their payment structure based on a director or an officer's desires to avoid potential losses, issuing a much greater portion of CEO and CFO compensation in the form of straight salary.²²⁰ Clearly such a shift would remove the benefits of incentive pay, which operates to align the interests of officers with the interests of the shareholders and cause them to have an incentive to promote innovation and success of the company.²²¹ Unfortunately, this result would also create a moral hazard by incentivizing those officers to do less work because their salary is guaranteed, and decreasing the value of the 304 "regret theory"

²¹⁵ *Id.* at 6 ("companies . . . will likely face increased rates and potentially restrictive terms.").

²¹⁶ Said, *supra* note 213, at D1 ("Without D&O insurance, people would be reluctant to be . . . executives because if something went wrong . . . they . . . might find their personal assets on the line.").

²¹⁷ See, e.g., James Denison, *Anticipated Coverage Issues Arising from Securities Actions Seeking Return of Ill-Gotten Gains*, 33 (No. 2) SEC. REG. L. J. 162 (2005); Johnson & White, *supra* note 140, at D1 ("Despite new laws and regulations, companies still face . . . a powerful motive for accounting fraud.").

²¹⁸ Dawes & Sorrell, *supra* note 54, at 6-7 ("D&O insurers are certain to review the information disclosed to them during the underwriting process with an eye for any material misstatements or omissions that would provide the insurer the right to rescind the policy. They are also likely to seek out various policy exclusions to deny coverage.").

²¹⁹ Kelsh, *supra* note 38, at 1042 (concluding that the language would still "accomplish [a] meaningful purpose" if a personal culpability requirement was read in).

²²⁰ Nelson, *supra* note 59, at 1192.

²²¹ 1-5 Tax Planning for Corporations and Shareholders (MB) § 5.03 (2008) ("The nature of stock options makes them an ideal method, in appropriate cases, for compensating the executive . . . a substantial increase in the value of the shares may give . . . an extremely valuable asset. The incentive thereby given to the employee to cause the corporation to prosper and grow can be tremendous."). However, there are some who theorize that "equity components of managerial compensation have been more severely decoupled from managers' contributions to company performance than appearances might suggest." Lucian A. Bebchuk & Jesse M. Fried, Symposium, *Pay without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 652 (2005). See also Johnson & White, *supra* note 140, at D1 ("Repeated studies have shown virtually no connection between high compensation and good corporate performance.").

incentives.²²² While the SEC may fear disrupting the balance of the market through heavy enforcement, a complete lack of enforcement will not accomplish its primary concern of “promoting the disclosure of important market-related information . . . and protecting against fraud,”²²³ and will specifically undermine the congressional intent of the Act.²²⁴

F. SEC is Progressively Implementing the Enforcement of Section 304 In Order to Allow Companies Time to Adjust

The theories thus far have underestimated the active role the SEC is taking in Section 304 enforcement, by ignoring the sudden spike in enforcement in 2007.²²⁵ This author believes that the SEC is aware of all the negative consequences that could result from enforcement of this provision,²²⁶ and has actively chosen to tread lightly. The SEC realizes that the market needs time to adjust²²⁷ and that the extensive and costly internal control systems, mandated by Sarbanes-Oxley, take time to implement and become operational before the new *misconduct catching systems* can actually catch the misconduct.²²⁸ The choice that the SEC made in light of this knowledge was to allow the companies a chance to develop systems to find the misconduct, disclose it to the public and take the opportunity to file the

²²² Di Lorenzo states that, “[R]egret theory, refers to the finding that individuals regret adverse consequences stemming from their actions more than adverse consequences stemming from inaction. Thus, risks from maintaining the status quo (e.g., risk of exposure to liability) are minimized while risks of changing the status quo (e.g., loss of profits) are exaggerated.” Di Lorenzo, *supra* note 10, at 789. By lessening the risk of liability, officers will spend less time monitoring and engage in more risky behavior, which is in direct conflict to the goals of the 304 penalty.

²²³ Securities and Exchange Commission, *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.sec.gov/about/whatwedo.shtml>. “Crucial to the SEC’s effectiveness in each of these areas is its enforcement authority.” *Id.*

²²⁴ See Nelson, *supra* note 59, at 1196 (“[T]he effectiveness of these provisions is dependent on the SEC’s . . . enforcing compliance with the provisions.”).

²²⁵ See *supra* Part III.C.

²²⁶ See *supra* Part IV.E.

²²⁷ Report, *Financial Restatements*, GAO-06-678, *supra* note 125, at 48 (“Currently, approximately 60 percent of public companies—generally smaller public companies—have yet to fully implement the internal control requirements of the Sarbanes-Oxley Act. . . .”).

²²⁸ Report, *Financial Restatements*, GAO-06-678, *supra* note 125, at 2, notes:

Industry observers expected that the number of public companies restating their financial statements would increase for some period of time because of increased scrutiny of internal controls over financial reporting, and then eventually level off as companies improved their controls.

restatements, without proverbially “throwing the book at them.”²²⁹ This allowed companies to file their restatements without fear that the reason they had missed some misconduct was because they did not have the structure in place to catch it. The SEC is not driven to hurt public companies or to drive them out of business (or at least out of public registration).²³⁰ This theory also acknowledges that as a government agency with limited resources it had to make choices about where to heavily pursue enforcement, and the SEC has been “a little busy” since 2002.²³¹

However, in looking at the five actions brought in 2007, an interesting trend is revealed that raises doubt about the SEC’s enforcement. In every one of these actions the CEO or the CFO, or both, have been a direct participant in the corporate fraud, and have assumed the role of the typical villain.²³² Hopefully, the SEC is using this provision in these cases as a first step in introducing this penalty into the enforcement arena, because to limit enforcement to only those who have committed fraud effectively changes nothing in enforcement and encourages CEOs and CFOs to turn a blind eye to potential corporate misconduct and proceed with business as usual. Some increased amount of enforcement under Section 304 is needed if the

²²⁹ For support of this see U.S. Treasury Secretary Paulson’s comments: “[I]mplementation has proven more costly and burdensome than originally anticipated . . . risk-based implementation will be a positive step. . . . Another emerging challenge is the soaring number of financial restatements . . . in 2006, there were 1,876, or more than 10 per cent of public companies. Restatements pose significant costs on our capital markets [and] have the potential to confuse investors and erode public confidence. . . .” Henry M. Paulson, Jr., U.S. Treasury Secretary, *The Key Test of Accurate Financial Reporting is Trust*, FINANCIAL TIMES, May 17, 2007, <http://www.treasury.gov/press/releases/hp407.htm>. The idea that the delay in the enforcement of Section 304 is based on the SEC’s perception that companies need time to adjust to new auditing requirements, therefore, it logically seems to flow from this discussion that, now, since companies are complying with Sarbanes-Oxley § 404 and have implemented the costly internal auditing procedures, the number of actions brought under Section 304 will substantially increase.

²³⁰ Securities and Exchange Act of 1933 § 2(b), 15 U.S.C. § 77b(b) (2006) (“the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”). See also CURRENT ENFORCEMENT, *supra* note 167, at 16 (“The agency generally has received praise for both its attempts at balanced regulatory policy and the tough but fair enforcement of the statutes and rules it administers.”).

²³¹ Bloomenthal, *supra* note 46, at *13 (“The Commission to the extent it has limited resources may have to establish different priorities, even if it means that blatant violations of the securities laws go unpunished.”).

²³² See *supra* Part III.C. at notes 141 & 142.

provision is going to promote the proper incentives and have the correct amount of deterrent effect.²³³

V. PROPOSED LEGISLATIVE REVISION: DO POTENTIAL CHANGES CHANGE TOO MUCH?

While the SEC continues to be resistant to any proactive use of Section 304 or any clarifying action to address the ambiguities raised in Part III.A., the same is not entirely true of Congress. Within the past year, two bills have been introduced that, if enacted, would dramatically revise Section 304 of Sarbanes-Oxley. This Part will look at Senate Bill 2866 and House Bill 6987, and analyze the changes and their likely effect if the language of the Bill were to be implemented as currently written.²³⁴

A. Senate Bill 2866

On April 15, 2008, Democrat Senator Hillary Clinton from New York introduced Senate Bill 2866, which, if enacted, would amend the current text of Section 304.²³⁵ This bill is the first affirmative attempt to address the ambiguities and problems with the enforcement of Section 304. However, this proposed legislation makes radical and potentially detrimental changes to some parts, while totally ignoring ambiguities in other parts.

If Section 3 of Senate Bill 2866 was enacted as written, the amended text of 15 U.S.C. § 7243 would read as follows:

(a) Additional compensation prior to noncompliance with Commission financial reporting requirements.

If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—

(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the *36-month* period following the first public issuance or filing with the Commission

²³³ See CURRENT ENFORCEMENT, *supra* note 167, at 14 (“Commissioner Goldshmid maintained . . . ‘[e]ffective deterrence requires a strong, credible threat [of enforcement],’ and that ‘[p]enalties must sting if they are to be effective.’”) (citations omitted).

²³⁴ This Note was last revised on January 22, 2009. As of that date there has been no committee discussion on S. 2866 or H.R. 6987, and neither Bill has been discharged from, or recommended out of, Committee.

²³⁵ 154 CONG. REC. S3025–26 (daily ed. Apr. 15, 2008) (introduction of S. 2866 by Sen. Reid for Sen. Clinton).

(whichever first occurs) of the financial document embodying such financial reporting requirement; and

(2) any profits realized from the sale of securities of the issuer during that 36-month period.

(b) *RULEMAKING TO IMPROVE ENFORCEMENT.*—

(1) *IN GENERAL.* Not later than 120 days after the date of enactment of the Corporate Executive Compensation Accountability and Transparency Act, the Commission shall develop and issue regulations to ensure more effective enforcement of subsection (a). In developing the regulations required under this paragraph, the Commission shall provide a comment period not to exceed 60 days.

(2) *REQUIRED INCLUSIONS.* The regulations required under paragraph (1) shall, at a minimum, *clarify*—

(A) that the term ‘misconduct’ includes misconduct that results from—

(i) specific illicit actions of a senior executive or officer, including the chief executive officer and chief financial officer, of a company, or knowledge of illicit actions, accompanied by willful inaction to address such illicit actions; or

(ii) the willful concealment by such executive or officer, of illicit actions; and

(B) that the term ‘illicit action’ includes any of the following activities:

(i) Backdating stock options to conceal liabilities, losses, or any other negative financial information from shareholders and investors.

(ii) Accounting irregularities designed to conceal losses, liabilities, or other negative financial information from shareholders, boards of directors, or government regulators, that are required to be disclosed under this Act, or any other Act, regulation, or rule governing securities.

(iii) Accounting irregularities designed to artificially achieve profit or other financial targets that would not have reasonably been met under generally accepted accounting principles and industry standards, or through compliance with—

(I) this Act, or any other Act, regulation, or rule governing securities; and

(II) any provision of the Internal Revenue Code of 1986.

(iv) Willfully circumventing the reporting, independence, due diligence, disclosure or fiduciary requirements and obligations of this Act, or any other Act, regulation, or rule governing securities in order to mislead, deceive, or withhold information that is required to be given to shareholders, boards of directors, and Federal and State regulatory authorities.

(v) Any conduct that violates, or is in conflict with, the legal and fiduciary responsibilities of the senior executive or officer to the shareholders and boards of directors of such executive or officer.

(c) *REPORT.*—Not later than 60 days after the date of enactment of the Corporate Executive Compensation Accountability and Transparency Act, the Chair of the Commission shall issue a report—

(1) analyzing the current enforcement efforts of the Commission in regards to this section; and

(2) listing the legislative, regulatory, or administrative recommendations of the Commission on how to remove any current barriers to effective enforcement of this section.

(d) COMMISSION EXEMPTION AUTHORITY.—

(1) IN GENERAL.—The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.

(2) NOTICE.—If the Commission exempts any person pursuant to its authority under paragraph (1), the Commission shall, not later than 15 days after such exemption is granted, issue a public statement explaining the factors surrounding the granting of such exemption and shall notify the chairperson and ranking minority member of the appropriate committees of Congress.²³⁶

This Author believes that the changes the proposed Amendment would implement can be broken down, by effect, into four independent categories, each of which will be analyzed in turn. These categories are: Time Period and Purpose; Clarification of “Misconduct”; Call for SEC Regulation and Enforcement; and Notice Accompanying Exemption.

1. *Changing the Time Frame: Unlinking the Cause and Effect*

The first and most drastic change present in the purposed amendment is the change from “12-month” to “36-month.”²³⁷ This is surprising because a three-year period of forfeiture does not appear to be readily tied to any period of time related to the restated filing, the triggering event.²³⁸ Each year publicly traded companies must complete and certify their annual SEC filing,²³⁹ therefore, a restated yearly filing seemed tied to the one-year period that the misleading information would have covered. A 12-month period of forfeiture is consistent with the notion that the funds being lost (designated as performance incentives) are being forfeited because the executive did not perform during that year, and their poor performance led to an incorrect yearly filing.²⁴⁰ A change to a three-year forfeiture period appears to enact a

²³⁶ For the exact language of the proposed amendment see Corporate Executive Compensation Accountability and Transparency Act, S. 2866, 110th Cong. § 3 (2008) (emphasis added).

²³⁷ S. 2866, 110th Cong. § 3(a) (2008).

²³⁸ Cf. Elaine Buckberg & Frederick C. Dunbar, *Disgorgement: Punitive Demands and Remedial Offers*, 63 Bus. Law. 347, 355 (2008) (“[C]ourts [have] found that the disgorged amount must be causally connected to the violation. . .”).

²³⁹ See Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m(a)(2) (2006).

²⁴⁰ One should note that this interpretation is different than a disgorgement approach. With disgorgement one only forfeits “ill-gotten gains,” or the amount that

highly punitive penalty, closely akin to treble damages in tort.²⁴¹ If this is the intended effect, this change seems to alter the statutory intent to that of a punitive penalty, rather than an equitable disgorgement, though both types of remedies would achieve deterrence of future bad acts, and encourage statutory compliance.²⁴²

However, the proposed language of other parts of the amendment confuses the issue. The title of Section 3 is: "Executive Reimbursement of Compensation for Misconduct."²⁴³ This title seems to suggest that this provision is intended to reimburse the issuer, and is no longer intended to be a penalty or incentive. Additional support for a reimbursement interpretation can be found in the language of (b)(2), defining "misconduct," which limit liability to acts or omissions.²⁴⁴ Reimbursement (or disgorgement) forfeitures are expected to be tied to a calculated measure of unjust enrichment, stemming from an act or omission.²⁴⁵ Changing the current statute in such a way would alter the originally intended purpose. A "36-month" period of forfeiture provides a set amount, similar to the penalty found in Section 906,²⁴⁶ rather than a variable amount which is calculated from the effect the defective restatement had on the stock value. Changing the time period in such a manner would be at direct odds with a policy of reimbursement of money lost.

Additionally, this alteration in the time period of forfeiture does not address or resolve the previous problems with the value of vesting incentives.²⁴⁷ Further, this provision actually complicates the matter in that

"compensation and bonuses[] are artificially increased by puffed-up corporate performance." Buckberg & Dunbar, *supra* note 238, at 349 (calculating disgorgement as a "net economic gain"). Reimbursement would be more typically a return of something earned to which one was not entitled, thus covering the entire yearly incentive based compensation and bonuses.

²⁴¹ Treble damages in tort are a punitive remedy, and "Disgorgement Should Not Be Punitive." *Id.* at 350.

²⁴² *Id.* at 350-51.

²⁴³ Corporate Executive Compensation Accountability and Transparency Act, S. 2866, 110th Cong. § 3 (2008).

²⁴⁴ S. 2866, 110th Cong. § 3(b)(2) (2008).

²⁴⁵ It is unclear whether Reimbursement or disgorgement is actually intended here. *See* discussion *supra* note 242. *Cf.* Buckberg & Dunbar, *supra* note 238, at 350 n.16 (unjust enrichment).

²⁴⁶ A three-year forfeiture period could be viewed as a superior penalty to that in Section 906, because, like the current statute, it is a penalty that is proportional to the wealth of the company and earnings of the corporate executive, avoiding the perception that the penalty is either overly burdensome or nominally deterrent. *See* Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C. § 1350 (2006) (\$ 5 million dollar penalty).

²⁴⁷ *See* discussion *supra* note 104 on benefits received, but not vested during the statutory time period.

now with a three-year period of time, successive restatements could lead to significant overlap, with either under- or over- recovery.²⁴⁸ A three-year period is no longer tied to the yearly certification, and could penalize a newly hired executive, who may have participated in the yearly audit and filing for the current year, but who was not even present, much less responsible for the two prior years. Ultimately, the inconsistency between the perceived intent and implemented means appears to add rather than alleviate ambiguity.

2. Definition of "Misconduct": Clarification or Alteration?

S. 2866 seeks to resolve the major source of ambiguity (and potential barrier to enforcement) found in the statutory term "misconduct."²⁴⁹ However, in defining the term, the Bill alters the nature of the statute by restricting the liability to "illicit actions" or "willful inaction to address such illicit actions" or "willful concealment."²⁵⁰ The use of the term "willful" suggests that there is a knowledge or an intent requirement,²⁵¹ and no longer applies to a situation where the executive has imputed knowledge, or should have known.²⁵² However, when viewed in context with the proposed definition of "illicit action" and the catch-all found in subsection "v" which encompasses conduct "in conflict with, the legal and fiduciary responsibilities,"²⁵³ it is possible that this provision can be read consistently with imputed knowledge and a standard that would encompass liability for recklessness or inattentiveness.²⁵⁴ It is also possible that since the definition is found in a section mandating rulemaking, the level of liability enumerated

²⁴⁸ If this is not tied to a yearly filing, but instead covers three years from the date of restatement, an additional problem of calculation and duplicate recovery is created. For example, if a company were to file a restatement two years in a row, is the forfeiture amount is equal to six years of bonuses or four years of bonuses with an off-set.

²⁴⁹ Corporate Executive Compensation Accountability and Transparency Act, S. 2866, 110th Cong. § 3(b)(2) (2008).

²⁵⁰ S. 2866, § (3)(b)(2)(A).

²⁵¹ BLACK'S LAW DICTIONARY 1630 (8th ed. 2004) (defined as "Voluntary and intentional," and further states "The word 'wilful' or 'wilfully' when used in the definition of a crime . . . means only intentionally or purposely as distinguished from accidentally or negligently and does not require any actual impropriety. . . .").

²⁵² One should note that the bill expands the coverage to all senior executives or officers not only the CEO and CFO. S. 2866, at § (3)(b)(2)(A)(i).

²⁵³ S. 2866, § (3)(b)(2)(B)(v).

²⁵⁴ To be consistent with the underlying purpose of Sarbanes-Oxley, Section 304 should be read to include liability for recklessness, or where one *should have known* of misconduct because of an inherent duty to investigate. Cf. ROBERT R. MOELLER, SARBANES-OXLEY INTERNAL CONTROLS 186–88 (John Wiley & Sons, Inc., 2008).

here is a floor that can be expanded rather than implementing a exclusive enumeration.²⁵⁵

Yet, one of the most interesting features of this bill is that the congressional intent clearly recognizes the ambiguity in the term “misconduct” and seeks to leave the clarification of this term to those with the most skill and familiarity with the law in the area, the SEC.²⁵⁶ If Congress is currently prepared to defer to the SEC’s expertise, and the SEC has the power to clarify the issue, this portion of the Bill merely emphasizes the SEC’s current failure to act.

3. Requirement of Notice After Exemption

The final addition of the public notice of reasoning for exemption adds additional clarification to the SEC’s understanding of its statutory role, but does not definitively resolve any of the original ambiguity surrounding this Section. The notice requirement appears to reinforce the holdings of the courts, following *Neer v. Pelino*, which held that there is no private right of action, because now the SEC must justify its actions for exempting someone from a Section 304 action.²⁵⁷ Providing justification to the public appears to be an attempt to establish a precedent of acceptable and unacceptable conduct under the section, clarifying the boundaries of the section.²⁵⁸ However, this also seems to confuse the process for exemption, making it unclear whether this provision is intended (or ever was intended) to impose automatic liability to the filing of the restatement due to misconduct. Additionally, the language used confuses the intended frequency with which the exemption authority should be used, further calling into question the extent and procedures for enforcement under this Section.²⁵⁹ The bill

²⁵⁵ It is not clear that the term “misconduct” would be limited to only that which is expressed here, rather the standard is the minimum. See S. 2866, 110th Cong. at § (3)(b)(2)(A) (2008)—“[r]egulations required under paragraph (1) shall, at a minimum, clarify that . . . the term ‘misconduct’ includes. . . .” It uses the term “includes” but not “is defined as”—leaving room open for other understandings to also be included.

²⁵⁶ The definition appears in Section b which is entitled “RULEMAKING TO IMPROVE ENFORCEMENT.” S. 2866, at § (3)(b)(2)(B).

²⁵⁷ *Neer v. Pelino*, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005). See also *In re BISYS Group Inc. Deriv. Action*, 396 F. Supp. 2d 463, 464 (S.D.N.Y. 2005); *Kogan v. Robinson*, 432 F. Supp. 2d 1075, 1082 (S.D. Cal. 2006).

²⁵⁸ It is unclear whether the justifications provided to Congress would create a standard of precedent with a stronger value than that of No-Action Letters, (i.e. pseudo-case law), or a weaker value than Staff Interpretational Guidance.

²⁵⁹ Compare S. 2866, at § (3)(d)(1), with S. 2866, at § (3)(d)(2). The attempt by Congress to require public notice, in what appears to be an attempt to define the appropriate conduct that should be subject to exemption, seems to confuse defining the exemption authority with defining the scope of the law and clarifying potential defenses

attempts to improve clarity and understanding, but should include an express statutory mandate that the SEC is the only body that can bring these claims, and that there is no private right of action in order to remove any outstanding doubt or confusion.²⁶⁰

4. A Call to Action and Demand for Reports and Regulations

The proposed amendment to Section 304 would accomplish one significant and positive change; it would force the SEC to act. Section “b” calling for clarifying regulations²⁶¹ and Section “c” calling for an internal assessment of barriers to enforcement²⁶² demand from the SEC the very action for which this Note is advocating.²⁶³ This Author fears that this proposed amendment would alter the optimal interpretation of Section 304, changing its purpose and effect, yet the proposed legislation has identified numerous current problems and is seeking to take corrective action. For this the legislative effort should be commended. The proposed legislation has identified the optimal means of corrective action: forcing the agency to issue regulations and evaluate enforcement efforts—ironically, action that is totally within the SEC’s current power.

B. House of Representatives Bill 6987

For the sake of a complete discussion, the second proposed congressional amendment to Section 304 must be briefly analyzed. The second bill, H.R. 6987,²⁶⁴ was introduced in the House on September 22, 2008.²⁶⁵ Unlike Senate Bill 2866, H.R. 6987 does not alter any of the language that is currently in Section 304, and does not seek to resolve any of the currently existing ambiguities.²⁶⁶ It instead would add a third subsection following the existing text to extend the scope of the forfeiture penalty to cover any executive of a company that is receiving a taxpayer bailout.²⁶⁷ If House Bill 6987 were enacted as currently written, it would introduce many

and justifiable executive actions. Exemption is a discretionary accommodation, not an avenue of defense to the violation. *Id.* One serves to clarify the other but the standard is not identical, nor should it be.

²⁶⁰ See Part III.A.4 *supra*.

²⁶¹ S. 2866, 110th Cong. at § 3(b) (2008).

²⁶² S. 2866, at § 3(c).

²⁶³ See *infra* Part VI.

²⁶⁴ H.R. 6987, 110th Cong. (2008).

²⁶⁵ See 154 CONG. REC. H8577-03 (2008) (statement of Rep. Feeney).

²⁶⁶ See *supra* Part III.A.

²⁶⁷ See H.R. 6987, 110th Cong., at preamble.

inconsistencies between the subsections of Section 304. Additionally, when the proposed text is read in conjunction with the old text, the proposed language would provide a harsher penalty to those executives who lack fault than is applied to those who are potentially at fault in causing the restatement.

If House Bill 6987 were enacted as written, the relevant parts of Section 304 would read as follows:

(a) **ADDITIONAL COMPENSATION PRIOR TO NONCOMPLIANCE WITH COMMISSION FINANCIAL REPORTING REQUIREMENTS.**—If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—

(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and

(2) any profits realized from the sale of securities of the issuer during that 12-month period.

(b) **COMMISSION EXEMPTION AUTHORITY.**—The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.

(c) **REPAYMENT OF BONUS IN CASE OF TAXPAYER BAILOUT.**—

(1) **IN GENERAL.**—An officer of an issuer shall pay to the Department of the Treasury any amounts received by such officer during a year as a bonus or other incentive-based or equity-based compensation from the issuer during—

(A) a year in which the issuer is subject to a taxpayer bailout; and

(B) the two years prior to a year in which the issuer is subject to a taxpayer bailout.²⁶⁸

This bill would create the same problem with the penalty and time frame for forfeiture as S. 2866 creates.²⁶⁹ However, this proposed amendment goes further. The Bill does not merely change the previous understandings and policies of the original Sarbanes-Oxley legislation; it actually creates inconsistent applications between the subsections of the same statute (e.g. Subsection (a) applied to the CEO and CFO while Subsection (c) applies to

²⁶⁸ See H.R. 6987, 110th Cong., Sec. 2 (2008). Taxpayer Bailout is later defined as a company being placed under some form of treasury control or supervision, or receipt of an emergency loan of public funds “to prevent the imminent failure of the issuer.” *Id.*

²⁶⁹ See Part V.A.1 *supra*.

all officers), without any apparent justification for the inconsistencies.²⁷⁰ Implementing subsection (c) would create an incongruous result that could not be intended under public policy. The penalty for being a CEO of a company that is having financial difficulties and becomes subject to a bailout is similar to treble damages, or the loss of three years of incentive compensation. Treble damages alone are not problematic,²⁷¹ but without revising the language or understanding of Subsection (a), CEOs who actually are responsible for the misconduct that led to the restatement would only forfeit one year's incentive compensation and bonuses.²⁷² This inconsistency would create a disincentive for competent CEOs and CFOs to accept positions with companies that might currently be financially unstable, if there is even the remote possibility that the issuer might become subject to a bailout. It is unclear if this type of a penalty would be an appropriate addition to the forfeiture provisions of Sarbanes-Oxley, given that there is no CEO conduct that could affect the attachment of liability.²⁷³ Serious revision, or the addition of conforming amendments, should be considered before Congress takes any further action with this Bill.

VI. RECOMMENDATIONS

It is highly doubtful that there will ever be such a perfect regulatory scheme that will accomplish total fraud prevention,²⁷⁴ but the SEC's haphazard enforcement of Section 304 is simply neglectful. The SEC should

²⁷⁰ See proposed statutory text *supra* pp. 39–41.

²⁷¹ The forfeiture of three year's pay under this proposal likely stems from a policy of market protection, and a general sense that if the issuer is failing financially, and the taxpayers are having to pay to remedy the problem, the individual in charge of the failing company should not retain the large incentives he or she given to promote financial success.

²⁷² It appears illogical to punish a CEO who may have had nothing to do with the financial instability of the company (especially in the case of a bailout, which is usually caused by unstable market conditions), three times as severely as one who may actually have perpetrated a fraud against the issuer.

²⁷³ It appears that both houses of Congress are favoring a forfeiture provision that functions as a penalty akin to treble damages. H.R. 6987, 110th Cong. § 2(c)(1)(A) & (B) (2008); S. 2866, 110th Cong. § 3(a)(1) (2008). Such harsh punishment does not seem to be appropriate in all scenarios that would be covered by Section 304. Congress may want to consider modifying future legislation to create two levels of penalties that could be invoked based on the level of liability of the executive. For example, fraud or misconduct that is knowingly committed by the executive could merit a 36-month forfeiture period, where as inattentiveness would invoke only the lesser 12-month forfeiture period.

²⁷⁴ See Johnson & White, *supra* note 140, at D7 (“[E]xperts stressed that crooks bent on stealing from a company will still take their chances and some will succeed. Regulators can never pass laws that will force executives to act with integrity. . . .”).

not delay enforcement of the current statute on the outside chance that Congress will enact a new statute, especially when the power to resolve ambiguity and enforce the statute is well within the SEC's agency powers.²⁷⁵ The SEC must provide guidance and clarity, creating a clear expectation of the statute's attendant liability, in order for enforcement to obtain maximum effectiveness. No statute can truly be effective if it does not provide adequate notice of prohibited conduct. The SEC should clarify its overall enforcement strategy and goals, and then take calculated steps towards enforcement actions that directly accomplish its policy objectives. Because to do nothing, and to leave executives guessing in the dark, is simply deplorable abandonment of valuable fraud prevention tools.

A. Issue Clear Interpretive Guidance to Resolve Statutory Ambiguity

The first step the SEC should take toward effective Section 304 enforcement is to issue clear interpretive guidance on the elements of the cause of action. The business community needs definition in order to anticipate appropriately liability and price risk,²⁷⁶ allowing for an efficient calculation of due diligence. Thus, while the SEC has an interest in avoiding simple "boilerplate disclosures,"²⁷⁷ it must be cautious of the fear that uncertain enforcement can create in the business community.²⁷⁸

The SEC should issue regulations that specifically resolve the textual ambiguities of Section 304, with specific attention being given to the meaning of the terms "required" and "misconduct." Several proposed

²⁷⁵ The SEC has rulemaking authority to facilitate the implementation of the Sarbanes-Oxley Act. *See* Securities and Exchange Act of 1933, 15 U.S.C. § 77s(a) (2002) ("The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out this subchapter."). Even a staff interpretation would provide additional guidance on the scope of Section 304.

²⁷⁶ Businesses need to be able to anticipate liabilities if they are going to properly function and actually reach a point of confidence that they have met appropriate standards for compliance.

²⁷⁷ SEC Action: Final Rule, Executive Compensation and Related Person Disclosure, at I.B.1, File No. S7-03-06, Aug 29, 2006, effective Nov. 7, 2006, 2006 SEC LEXIS 2016 (SEC 2006) at *41, <http://www.sec.gov/rules/final/2007/33-8809.pdf> (The Commission stated while adopting the revised rules that "[t]he purpose of the . . . disclosure is to provide material information about . . . objectives and policies . . . without resorting to boilerplate disclosure.").

²⁷⁸ CURRENT ENFORCEMENT, *supra* note 167, at 19 ("The Commission is seen as increasingly attempting to impose shifting standards of conduct and liability through enforcement proceedings. This reportedly has caused a sense of uncertainty to envelop the business community, along with a fear that the Commission will impose a standard of liability that has not been clearly enunciated.").

definitions have been put forth for when a restatement is “required,”²⁷⁹ but by using an interpretation that relies both on the internal controls and audit procedures to identify the misconduct, it places the ultimate burden back on the CEO and CFO to acknowledge an accounting discrepancy and take appropriate remedial action to correct material misstatements.²⁸⁰ It also creates a policy incentive for the CEO and CFO to ensure issuer compliance and to carry out their monitoring functions diligently, so that the misconduct and accounting irregularities are discovered and remedied before material information is disclosed in quarterly reports.

When defining the term “misconduct” the SEC should give special attention to the level and form of liability imposed by different language and meanings. At least four possible levels of liability have arisen from academic analysis of this term: (1) direct liability for “personal culpability;”²⁸¹ (2) liability for “inattentiveness” or negligent supervision, or what one “should have known,” which would encompass a standard of recklessness akin to that found in several provisions of the 1934 Act;²⁸² (3) remote liability, where either the negligent or intentional action of a remote employee can constitute enough misconduct to impose liability;²⁸³ and (4) strict liability, allowing no affirmative defense for reasonable investigation or due diligence. There is little argument that direct liability should be included in the standard for “misconduct,” given that it is this standard which punishes the atrocious fraudsters who deliberately set out to defraud the market and the public.²⁸⁴ If liability were to stop there, the effect being given to the text would appear to be narrower than the text appears on its face.²⁸⁵ Liability for inattentiveness should be included in the definition of misconduct due to the policy goal of providing the public with reliable information; the justification is that an

²⁷⁹ Fraidin et al., *supra* note 37, at 56.

²⁸⁰ Eigenbrodt, *supra* note 81, at 2 (defining as “‘required’ when the restatement is necessary for an issuer’s auditors to issue their opinion on the financial statements . . .”). See *supra* Part III.B.

²⁸¹ See generally, Kelsh, *supra* note 38.

²⁸² See, e.g., 15 U.S.C. § 771 (2006) (reasonable care).

²⁸³ It is generally inconsistent with the understanding of the term misconduct that derived liability from an innocent mistake. See Dawes & Johnson, *supra* note 30, at 116.

²⁸⁴ This provision would be meaningless without punishing those who, through their intentional conduct, are little better than street thugs. Direct liability is also wholly consistent with other anti-fraud penalties found in Sarbanes-Oxley. See Rule 10b-5, 17 C.F.R. § 240.10b-5 (2008).

²⁸⁵ Congress in drafting Section 304 could have written subsection (a) as:

If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, with any financial reporting requirement under the securities laws, as a result of misconduct by the chief executive officer or chief financial officer of the issuer, or both, then that officer shall reimburse the issuer for. . .

inattentive officer is not exercising enough care to satisfy the knowledge requirement.²⁸⁶ Including the second standard suggests that the appropriate level of liability is recklessness, which definitively removes the defense of ignorance, but retains a form of the affirmative defense of due diligence.²⁸⁷ By including the due diligence defense, the standard of liability becomes flexible and adaptive.²⁸⁸ There is somewhat of a gray area between the second and third standards (due to the standard given to “should have known”), which exists on a sliding scale of remoteness of relationship versus severity of misconduct.²⁸⁹ The appropriate definition for misconduct falls somewhere in the gray area, and ultimately judicial decision would define the outer bounds.²⁹⁰ To include the fourth standard of liability would produce disincentives for officers to diligently monitor disclosures,²⁹¹ and would only expand market fear over unreliable enforcement.

The SEC needs to be explicit when describing a Section 304 action. By merely taking those steps the SEC will allow the business community to

²⁸⁶ See Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703, 706 (2007) (“Congress . . . reasonably concluding that executive certification would be more meaningful and persuasive to investors if those executives had reasonable grounds to believe that the internal financial controls on the process producing those numbers were solid.”).

²⁸⁷ This is consistent with the § 302 certification requirement that the certifier is attesting “to the best of his knowledge.” See Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006).

²⁸⁸ Recklessness and due diligence are terms which could be defined by regulations or develop an understood meaning through SEC adjudication and case law. This type of standard is one that can shift to accommodate different factual scenarios as well as historical developments in precedent.

²⁸⁹ Thus as the relationship of the person committing the misconduct becomes more attenuated (e.g., a manager of a small overseas subsidiary, whom the CEO has never met) the more egregious the misconduct must be for liability to attach (e.g., blatantly misappropriating a significant percentage of corporate funds to pay for a forty-foot personal yacht). See Carney, *supra* note 86, at 144 (“The earliest change imposed by SOX on executives involved the section 302 requirement that Chief Executive Officers (CEO) and Chief Financial Officers (CFO) certify the accuracy of financial statements. This has created a daisy chain effect in which these officers require lower-level employees to certify accuracy of those portions of the financials for which they are responsible, and is creating a practice of a series of meetings down the line to discuss control issues.”) (citations omitted).

²⁹⁰ CURRENT ENFORCEMENT, *supra* note 167, at 37–38 (“[T]here is concern that the SEC is taking enforcement actions designed to raise those standards based on the Commission’s view, after the fact, of what corporate officers . . . ‘should have’ done or ‘should have’ recognized, and that the view being imposed greatly diminishes the ability of managers to function without fear of being second-guessed when they rely in good faith on the involvement of competent subordinates. . . .”) (citations omitted).

²⁹¹ Cf. Said, *supra* note 213, at D1.

anticipate executive exposure and to put into place firm policies targeted at preventing the misconduct that might trigger the exposure. No market can function if governed by rules that are vague or inconsistently applied.²⁹² It is firmly believed that that no firm wants to violate the Sarbanes-Oxley requirements;²⁹³ rather, they just are not clear on what the requirements are, and what minimum threshold they must meet to escape liability.²⁹⁴

B. Develop Comprehensive Enforcement Policies and Guidelines

The second recommendation is integrally connected to the first. The SEC needs to determine what the optimal outcome for enforcement of Section 304 should be, and then should “undertake a comprehensive study of its enforcement processes and policies, to ensure that the rights and interests of all those constituencies that work within the framework of regulation . . . are adequately considered and protected during the enforcement process,”²⁹⁵ and that the enforcement is effected in a manner that focuses on the harm that Congress intended to remedy by the enactment of the Section 304 language. Once the interpretational ambiguities are resolved, the statutory text of Section 304 should become the framework for enforcement, detailing the elements of the cause of action, the burden of proof, the threshold for liability, and the potential for an affirmative defense.

As part of these guidelines, the SEC should explicitly address the issue of the existence of a private right of action. The courts have given their

²⁹² CURRENT ENFORCEMENT, *supra* note 167, at 15 (“[T]he threat of harsh, punitive sanctions for violations based on complex and unclear legal and accounting principles, and the over criminalization of securities law violations, can stifle creativity and legitimate risk-taking and create a liability-imbued and uncertain environment in which to do business.”). See *Koyo Seiko Co. v. United States*, 36 F.3d 1565, 1570 (Fed. Cir. 1994) (citing *Zenith Radio Corp. v. United States*, 437 U.S. 443, 450 (1978)) (“To survive judicial scrutiny, an agency’s construction need not be the *only* reasonable interpretation or even the *most* reasonable interpretation. Rather, a court must defer to an agency’s reasonable interpretation of a statute even if the court might have preferred another.”)

²⁹³ Harshbarger & Jois, *supra* note 80, at 9 (“business leaders might want to act but are unsure how”).

²⁹⁴ CURRENT ENFORCEMENT, *supra* note 167, at 23 (“SEC Commissioner Cynthia Glassman stated that she favors continuing ‘to push for more focus on encouraging good outcomes proactively rather than looking for violations after the fact,’ . . . ‘[b]y setting clear standards, we can make it easier for regulated entities to comply with our rules. . . .’”) (quoting Cynthia A. Glassman, U.S. Sec. & Exch. Comm’n, Speech by SEC Commissioner: SEC in Transition: What We’ve Done and What’s Ahead (June 15, 2005), available at <http://www.sec.gov/news/speech/spch061505cag.htm> (last visited Oct. 15, 2008)).

²⁹⁵ CURRENT ENFORCEMENT, *supra* note 167, at 40.

support for the interpretation that no private right of action exists under Section 304, and the SEC has begun to enforce such actions, allowing the market to draw such a conclusion. But a definitive statement of the policy in this area would save the plaintiffs' bar the aggravation of having to plead frivolous claims out of fear of repercussions.²⁹⁶ The SEC must ultimately find the appropriate balance of enforcement and harm to instill in this statute the correct deterrent effect.²⁹⁷ "What is needed is a legal regime that motivates corporate actors to commit to legal compliance rather than to seek ways to avoid or evade the law,"²⁹⁸ but this can never be fully accomplished if the SEC continues to enforce Section 304 in an erratic and unpredictable manner.²⁹⁹

VII. CONCLUSION

To find corporate misconduct requires having someone on the inside motivated to look for it. The Sarbanes-Oxley Act realized this, but one still has to wonder if it effectively created this motivation.³⁰⁰ If enforcement under Section 304 is not either increased or revised in the coming years, then the public would be naïve to believe that either the Sarbanes-Oxley Act or the SEC has successfully protected them against corporate misconduct and ensured them full disclosure.³⁰¹ However, this Author is hopeful that the SEC will shortly promulgate regulations that will clarify the statutory text of

²⁹⁶ This would also add a level of clarity that might prevent an end-run around the statute by bringing such claims in arbitration. *See Om Group, Inc. v. Mooney*, No. 2:05-cv-546-FtM-33SPC, 2006 U.S. Dist. LEXIS 1446, at *2 (M.D. Fla. Jan. 11, 2006); discussion *supra* note 116.

²⁹⁷ *Cf.* CURRENT ENFORCEMENT, *supra* note 167, at 37–38 ("[T]here is concern that the SEC is taking enforcement actions designed to raise those standards based on the Commission's view, after the fact, of what corporate officers . . . 'should have' done or 'should have' recognized, and that the view being imposed greatly diminishes the ability of managers to function without fear of being second-guessed when they rely in good faith on the involvement of competent subordinates, counsel, or other experts." (citations omitted)).

²⁹⁸ Di Lorenzo, *supra* note 10, at 795.

²⁹⁹ CURRENT ENFORCEMENT, *supra* note 167, at 19 ("The Commission is seen as increasingly attempting to impose shifting standards of conduct and liability through enforcement proceedings. This reportedly has caused a sense of uncertainty to envelop the business community, along with a fear that the Commission will impose a standard of liability that has not been clearly enunciated.").

³⁰⁰ Coffee, Jr., *supra* note 61, at 337 ("Arguably then, the Sarbanes-Oxley Act represents an incomplete response—relevant in its desire to reduce agent conflicts of interest, but still not sufficient to the extent that underdeterrence [sic] remains the problem.").

³⁰¹ Di Lorenzo, *supra* note 10, at 793–97.

Section 304, and that future enforcement actions will target those inattentive officers who have failed to find the corporate misconduct being perpetrated right under their noses.

